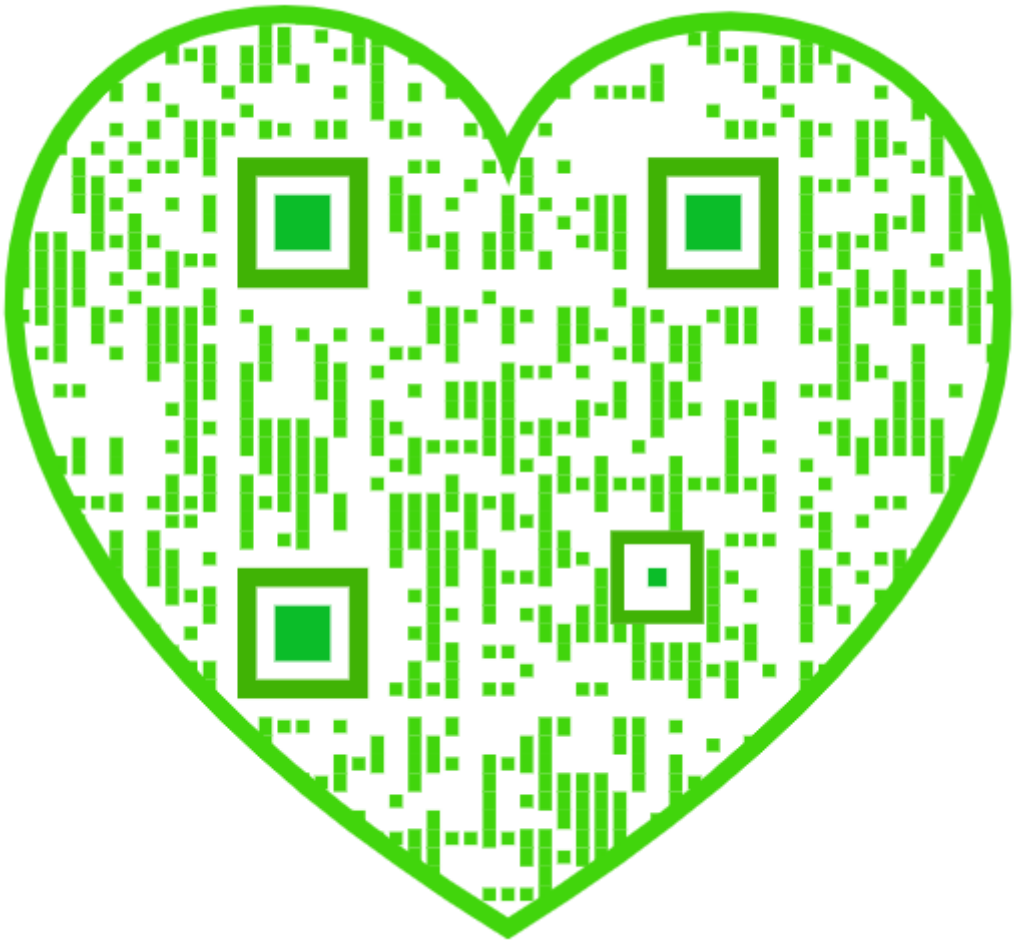

ELEMENTS OF POLITICAL ECONOMY

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ELEMENTS

OF

POLITICAL ECONOMY

BY

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PREFACE

THIS work is intended primarily for the use of students. The leading principles are stated, as far as possible, without the introduction of controversial matter. At the same time, throughout the work indications are given of the points still in dispute and of the difficulties involved in the further development of the principles and theories of which an elementary exposition is given. The work is based on the "Principles of Political Economy" (3 vols.) by the same author. It is, however, not simply an abstract. In the first four books the material used has been almost entirely recast. In the last book it was thought better to omit certain topics altogether rather than attempt any further condensation of the argument.

In order to keep the volume within reasonable limits the greater part of the historical matter which forms a characteristic feature of the larger work has been excluded, though the results of the application of the historical method have been retained. Little space also was available for the history of economic thought and doctrines. In the text, however, the importance of these and other omitted topics has been emphasised, and the student is recommended throughout to supplement his reading by reference to special works. At the end of each chapter references are given to books which the

author has found useful and suggestive, and it is hoped that the selection as far as it goes is representative and impartial.

I am more than usually indebted to Mr. A. B. Clark, M.A., my assistant in the University, not only for his supervision and correction of the proofs, but also for the very full index.

J. SHIELD NICHOLSON.

UNIVERSITY OF EDINBURGH,
October, 1903.

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ELEMENTS OF POLITICAL ECONOMY

INTRODUCTORY

SCOPE AND METHODS

1. The Magnitude of Economic Literature. — In 1845 there was published a book which now has a considerable scarcity value; namely, the *Literature of Political Economy*, by J. R. McCulloch. This work is described as a classified catalogue of select publications in the different departments of that science. It begins with the general treatises and the fundamental principles, occupying some thirty pages; the second chapter, on commerce and commercial policy, is divided into ten sections and covers more than a hundred pages; and there follow eighteen more chapters on various topics, *e.g.* money, banks, prices, roads, canals, railways, statistics, fisheries, insurance, interest, population, wages, poor laws, property, successions, revenue, and finance, concluding with a chapter entitled miscellaneous. The index of authors gives about eight hundred names, and the index of books about double that number. Even in 1845 the work only professed to give a selection, and since that time attention has been directed to many works not noticed by McCulloch, of high value in economic literature. The number of works that have been written since 1845 is enormous, and of recent years the rate has been increasing

rapidly. Some idea of the present range of economic studies may be formed by a glance at Palgrave's *Dictionary of Political Economy*, in the compilation of which he had the assistance of nearly two hundred experts. It is not only in England, or even principally in England, that this growth of economic literature is observed. In Germany, Austria, the United States, in France, Italy, Switzerland, and Holland, many books have been written in every department, and in addition there are a number of special journals devoted to the subject. Such and so great is the literature of economics. It follows at once that it is quite impossible to give any adequate idea of this literature in an elementary treatment of principles.

At the same time it may be observed that the study of economic literature is probably of more importance than the study of the literature of almost any other science. In most sciences the latest authority may be expected to have digested or at least to have congested the best results of his predecessors. But in economics we cannot fully appreciate the real meaning of fundamental conceptions and leading principles without tracing their gradual development. And especially if we wish to understand the industrial and commercial or more generally the economic history of a people, we must understand the ideas by which it was dominated at various periods; and in his standard work on the economic history of England Dr. Cunningham has done well to introduce chapters on opinions, ideas, and theories, although economic history is concerned with the positive treatment of facts and institutions.

There are also great advantages to the student in reading at first hand the works of the principal writers.

Adam Smith's *Wealth of Nations* cannot be reduced to an abstract, and the attempt to frame a short and simple creed of economic doctrine out of this elaborate work was not only a failure, but caused very great mischief. And even as regards many forgotten writers and obscure pamphlets, it is surprising what may be gained. The great writers, notably Adam Smith himself, fed largely on the little writers.

The history of the development of economic theories is an important study for which there is ample material. In the present survey of principles, however, it can only be introduced occasionally by way of illustration.

2. Of the Relation of Political Economy to Other Sciences. — The progress of all the sciences has been associated with ever increasing specialisation. When Adam Smith was Professor of Moral Philosophy in the University of Glasgow, his course of lectures was divided into four parts. The first embraced Natural Theology; the second, Ethics in the narrow sense of the term; the third examined more at length "that branch of morality which relates to justice," and it is noteworthy that in dealing with this subject he adopted largely the historical method; and in the fourth part he gave the lectures which were afterwards expanded into the *Wealth of Nations*. His course on Ethics was the foundation of the essay on the theory of Moral Sentiments which was in its day as famous as his economic work; and he had intended to develop his course on jurisprudence in a similar way, but was overtaken by old age and sickness. The separation of economics from ethics and jurisprudence was an example of the necessity of specialisation after a certain point had been attained;

and it also explains the emphasis laid in the *Wealth of Nations* on one part of social and political life to the apparent exclusion of interests of at least equal importance. So far from underestimating the principles of morality, law, and religion, he supposed that they were of such importance that they required special investigation. The object of the course on economics is recorded by one of his students in these words: "In the last part of his lectures he examined those political regulations which are founded, not on the principle of *justice*, but on that of *expediency*, and which are calculated to increase the riches, the power, and the prosperity of a state. Under this view he considered the political institutions relating to commerce, finance, and to ecclesiastical establishments," and there may be added to this account, the expense of the administration of justice and of the provision of national education in the broadest sense of the term.

This specialisation of economics was continued by the English successors of Adam Smith with few exceptions, and indeed by the systematic writers it was carried farther, that is to say, the field of inquiry was contracted and stress was laid on the scientific character of Political Economy as distinct from its practical applications. Recently however, in the reaction against this excessive specialisation, there has been a tendency to bring in on the one side moral and political considerations, and on the other to give the science a more practical character in relation to business in the narrow sense of the term. Without expressing any opinion on the controversy involved, regarding this change of attitude, it is sufficient in this place to state that the scientific treatment of eco-

nomic principles and methods, to the exclusion of these various moral and social influences and of various practical applications, is a subject of sufficient importance and difficulty for specialisation, and forms the best introduction to these wider and more practical applications. To take one or two examples: the theory of money is a necessary preliminary to banking; that of monopoly values, to trusts; that of wages and profits, to trade unions; that of the incidence of taxation, to finance, — and the list might be extended indefinitely. It is not too much to say that every day the newspapers offer problems that involve, for their adequate understanding and an appreciation of their bearings, the use of economic methods and principles, but it would be impossible to anticipate the actual problems that will arise. The social reformer, the legislator, and the man of business (whose name is legion) will all benefit from the preliminary study of scientific economics, although the special problems in which they are interested are not treated in the text-books. In precisely the same way the engineer may benefit from mathematics, the miner from geology, and the navigator from astronomy, although the industrial arts are not directly treated of in the corresponding sciences.

At the same time it is, no doubt, often desirable to illustrate the theory by reference to actual or historical examples that in themselves are interesting and important; although, on the other hand, in certain parts it is better to show the abstract nature of the treatment by making an avowed use of hypothetical examples.

3. The Scope and Definition of Political Economy. — The scope of Political Economy may be indicated by show-

ing its relation to other sciences. It must be classed with the group of moral or mental sciences because it deals primarily with human beings as possessing certain moral or mental characteristics. Its fundamental conceptions always have reference to qualities of mind. It is true that sometimes physical facts are of great importance. Thus, it is often said that the laws of production partake of the character of physical laws, *e.g.* the law of diminishing return; and often definite appeals are made to physical facts and conditions, *e.g.* in treating of the causes affecting the efficiency or the degradation of labour, or the influence of natural resources and climatic conditions on the production and accumulation of wealth. But the end in view is not the mere statement of physical facts, but their relations to human beings. Wealth itself is treated as giving pleasure and involving effort, and not as possessing weight, extension, or other physical characters; that is to say, it is considered from the human standpoint. During the first half of the nineteenth century great social evils arose from the materialisation of wealth, or forgetting the end in the means.

Of the moral sciences some treat mainly of the individual, *e.g.* psychology, some of the social relations of human beings, *e.g.* jurisprudence. The term *political*, taken in its original sense, implies that in the main economic science deals with man in his social relations. Sometimes, no doubt, in the preliminary explication of conceptions, it is useful to isolate the individual, *e.g.* in treating of utility we may begin with the direct consumption of the individual. Also in the study of the

motives to action we may begin with the individual and in general before considering the probable effects of legal regulations, it is best to show the probable results, if individuals are left to their own devices. But the object in view is always to discover the effect on the whole society or some group, and not merely on the individual.

Again, in its mode of dealing with social phenomena, political economy must be classed with the positive sciences. In the main, it deals with facts and not with ideals; it observes certain kinds of social facts in order to make classifications, and to discover uniformities and causal connections. It describes what has happened in the past, or is actually occurring in the present, and will probably occur in the future under similar conditions. But strictly speaking from this positive standpoint, it does not lay down moral precepts or deliver moral judgments. And the reason is not that moral and religious elements are not of importance in practical problems, but simply that they are outside the sphere of economics. If Adam Smith found it desirable in the eighteenth century to separate economics from morality and religion, that is to say, for scientific treatment, the presumption is that in the twentieth century this specialisation must be retained. And it is observed in the study of economic history, that, as a matter of fact, the economic elements can be considered apart. No doubt the moral and the religious ideas of people often have indirectly an economic influence, but again, as throughout, it is a question of emphasis. We may, for example, consider the economic aspects of the mediæval church apart from

its moral or religious teaching. And similarly, in investigating present conditions, we can distinguish between the positive examination of facts, and the suggestion of reforms with the view of promoting certain ideals. We may, indeed, in some cases go beyond the actual facts and pass from the past and the present, to the future, and consider the probable effects of various proposed economic reforms. But even here we are in the domain of facts in so far as these proposals are such as to modify human action and are not purely imaginary. Thus we may discuss socialism, and consider the meaning, the advantages and disadvantages, etc., on the ground that socialistic ideas influence present legislation and economic action — in other words, the socialistic tendency of much modern governmental action is an economic factor that must be taken account of. But in considering any social reform or proposed remedy, we must remember that, in general, there are more than the economic elements to be considered. Wealth, the subject-matter of economic inquiry, even in the most extended meaning and having regard to its remote influences, is only one element of civilisation, and often not the most important.

Political economy, then, may be defined as the science which investigates the nature and the causes of the wealth of nations; it seeks to discover the laws affecting the production and the consumption, the distribution and the exchange, of wealth. All of these terms, it will appear in the sequel, require careful analysis.

4. The Uses of Definitions in Economics. — Most words used in economics are used also in ordinary language or at

any rate in the language of the market-place, and there are relatively few technical terms. The question then naturally arises, Why should we waste time over definitions and explanations when the words are already familiar? The answer is that this very familiarity is deceptive and sometimes conceals real difficulties, and sometimes leads to positive errors. If we search carefully into the meaning of these familiar terms, we shall often be led to notice important facts instead of stopping at a verbal explanation. For a long time people were accustomed to say that wages were high because capital provided a large wages fund, which in most cases had no more meaning than the assertion that the labourers receive much, when the employers pay much, in wages. But the inquiry into the meaning of this familiar expression led to the discovery of the true relations between labour and capital. Again, people were accustomed to say that the fall in prices that set in in gold-using countries after 1874 was caused by the appreciation of gold, and in most cases this had no more meaning than the statement that the fall in prices was caused by the fall in prices. But the inquiries that were made as to the meaning of these expressions were again, to say the least, fruitful in their results. Real difficulties were exposed and some advances were made towards their solution.

But very often this familiar use of economic terms led people into positive errors, and even governments into mistaken lines of action. Most of the crude fallacies of protection can be exposed by the careful analysis of the terms employed. The idea, formerly so prevalent and still not extinct, that the advantage of foreign trade can

be measured by the excess of exports over imports is shown to be fallacious by analysing the terms. Similarly also, many of the popular fallacies regarding the connection between labour and prices, consumption and production, low wages and cheap labour, may be got rid of by a consideration of what ideas the words stand for. It is true that in all these cases much more than verbal analysis is required, but in all cases also it is a necessary preliminary.

Some of the definitions of terms in constant use prove on inquiry to involve such difficulties that a simple definition is impossible, *e.g.* capital, money, etc. Accordingly it is found desirable to lay down certain rules for definitions in economics. The rules now generally accepted are as follows: —

5. **Rules for Definitions.** — (1) As far as possible our definition should coincide with the best popular usage. Otherwise, if a writer gives a different meaning in the course of his argument, he may be led by association to use the term in its popular sense, and thus be involved in error; or even if he himself escapes the confusion, his argument may be misunderstood and misquoted. This difference between the popular and the quasi-technical usage is the source of many of the popular delusions regarding the teachings of economists. Thus, for example, in the pure theory of economic rent, the term is used in a sense far more narrow than the popular meaning. The proposition that with the progress of society rents tend to rise was only held in reference to these economic rents, but when used in popular arguments in reference to unearned increments the wider meaning was given.

Similarly, the economic use of the terms *labour* and *wages* is much wider than in popular discourse; and propositions which economists have framed with regard to labour in the wide sense are repeated with the narrower meaning. In the economic sense all wealth may be said to be the result of labour, if we include the highest professional skill, the labour of "first occupancy," and an endless number of forms of human activity besides mere manual labour. But too often, in popular discussions, what is attributed by the economists to labour in general is confined to manual labour in particular.

The only safeguard seems to be to make a liberal use of qualifying adjectives, so as to indicate the precise meaning intended. Thus the money of the money market consists only to a small extent of actual coin or even notes, whilst on the other hand a large part of gross profits in economic analysis appears as a form of wages. It is often of the highest practical importance to distinguish between the different forms of money and the different forms of wages, and the distinctions are best indicated by the use of appropriate qualifying terms, *e.g.* standard money, wages of management, etc.

(2) The second rule, closely connected with the first is that definitions should not be made too rigid or precise. The nature of the subject does not admit of the accuracy that is possible in some parts of mathematics. Conceptions and ideas which are very different in extreme cases often overlap or admit of debatable margins. The recognition of continuity, and of resemblance in difference, is much insisted on by recent writers. It is usual to say that there are three great agents of production of wealth: namely,

land, labour, and capital. And in simple cases nothing can be more clear than the differences implied. In north-west Canada we distinguish readily and clearly between the land, the labour of the immigrants, and the ploughs and other implements which they have to purchase. Land, capital, and labour seem quite different in kind. But on analysis in a complex industrial society, the distinctions are often by no means clear. Thus labour and capital are in many respects so much alike that Adam Smith includes the natural and acquired abilities of a people under the fixed capital; similarly also, for many purposes, land is placed under capital.

(3) In different parts of the subject, stress is laid on different characteristics of a complex conception; and it is advisable to begin with provisional definitions of a general character and later on to frame special definitions for special purposes. Thus, we may begin with a definition of money which calls attention to its function as a general medium of exchange, and later the special function of legal tender may be made prominent.

(4) After all, it must be remembered that "words are the servants of things" and in some cases it may be desirable to make a new technical term or to give to an old term a special meaning. Some writers have maintained that in scientific language we ought only to use scientific terms. "In each particular science we are never concerned to know what are the meanings attached to the term either in vulgar parlance or in any other science" (Pantaleoni). But it may be objected that economic science draws much of its materials from facts expressed in common language, and to understand the facts we must exam-

ine the language; and even pure economics, to be of any value, must not be so abstract as not to be capable of application to the actual world. And again, political economy also draws largely from other sciences, and it would cause endless confusion if the words are to be employed in totally different senses. The better opinion, then, seems to be that technical terms ought not to be multiplied beyond necessity. The use of a new word is a very different thing from the discovery of a new idea.

(5) It is sometimes useful to supplement the positive definition by considering the opposite — to state not only what is included, but also what is excluded. Thus, the meaning of equality of taxation may be clarified by reference to the marks of inequality. In the same way, when we test our definitions by instances — in logical phrase the connotation by the denotation — it is well to take examples of the negative as well as of the positive.

(6) Finally, it may be added that just as it is well not to diverge from the popular meaning without cause, so also, if a quasi-technical meaning has been generally adopted by economic writers, that meaning should not be altered without sufficient reason. If every writer is to give his own shade of meaning to every term, a vast amount of unnecessary labour will be required.

6. The Methods of Political Economy. — Economists have used two distinct methods, or rather groups of methods, to which different significant names are applied according to the stress laid on different characteristics.

In the first place, we have the methods known according to their special uses as deductive, *a priori*, abstract, hypothetical, mathematical, analytical, etc.; and secondly,

we have the methods styled inductive, positive, *a posteriori*, historical, comparative, etc.

In the typical deductive method we start with certain broad facts, obvious from observation, or with principles supposed to be already established. From these general propositions we deduce some particular conclusion. We then refer to experience to test or verify this deduction. Then if we discover that there is not an exact coincidence, we try to discover the disturbing causes.

In the typical inductive method we start with the observation and classification of concrete facts and ascend to general principles. We may conversely test our inductions by using them as the basis of new deductions.

In its extreme form the deductive method starts with hypotheses, and proceeds to draw conclusions by the aid of mathematics. It is possible that the hypotheses may be so remote from facts that the only use of the method in this form is didactic. Similarly also, in its extreme form the inductive method may never advance beyond the first stage, namely, the collection or observation of facts. Masses of facts have been recorded by various royal commissions in England, which are stored away in blue books. Again, in the works of Anderson, Macpherson, Eden, Tooke, Newmarch, Rogers, Vicomte d'Avenel, and many other economic historians, only a relatively small part of the material has been used for scientific purposes.

On the other hand, however, even the most extreme forms of the deductive method have often led to a more adequate and true interpretation of facts; and again, the

collections of facts and figures which had been set aside as useless have come to be of the highest importance.

It is now generally admitted that all these various methods, or these various forms of the deductive and inductive methods, are applicable in various cases. In certain parts of the subject, *e.g.* in the theory of value and of money and prices, it is necessary in the first place to begin with the deductive method and to use hypotheses. In other parts, *e.g.* in considering the causes of the efficiency of labour, or the effects of climate on production, induction is necessary from the outset. In the present survey numerous examples will occur of these various methods, so that further illustration is unnecessary.

7. The Laws of Political Economy. — The conclusions arrived at by the use of these various methods are in some cases styled the laws of political economy. This phrase has been much misunderstood, and requires careful analysis. The meaning of the expression may be considered with advantage both positively and negatively.

(1) Positively, the laws of political economy may be divided into two classes, according as the conclusions on which they are based are obtained from the use of the deductive or the inductive methods respectively.

The laws due to the deductive method are in general abstract or hypothetical, and so long as the conditions laid down hold good they are necessarily true. That is to say, if the premises are admitted, the conclusion depends simply on correct reasoning. Take, for example, Gresham's law, which in its popular form states that bad money drives good money from circulation. So long as

the conditions are fulfilled, the result follows. But in practice it rarely happens that the conditions answer the strict requirements of the theory. Even in this relatively simple case we often find bad and good money circulating side by side. Generally it may be said that these abstract or hypothetical laws are only true in the absence of disturbing causes.

The laws due to the inductive method are in general empirical, and cannot be far extended in time or space. That is to say, the probability is that in different times and places there will be an essential change in the conditions. Thus, the law of population laid down by Malthus was based on an inductive inquiry, and was carefully worded. But as popularly expressed in a summary form, it is supposed to state that population will always increase if food increases. In certain cases this generalisation is adequate and correct; the recent experience, however, of several great countries, notably France, shows that the law in this summary form does not hold good. Similarly, all arguments that are based on appeals to history or to the experience of other countries, or in other words, all the so-called laws due to the historical and comparative methods, can only be safely applied to new cases if we are assured that the essential conditions are similar. It follows, generally, that the laws of political economy when applied to the explanation of facts, or the advocacy (or condemnation) of proposed reforms, have varying degrees of force. In the classical phrase they express tendencies only, and are liable to be counteracted.

(2) Negatively, economic laws are to be distinguished both from legal enactments and from moral rules; they

are not commands or imperatives. It is one thing to point out the meaning, causes, and effects of certain lines of conduct, and quite another to assert that therefore certain rules ought to be obeyed. When the authority of the classical economy was at its height in popular estimation, no phrase was more in vogue in political discussions than "contrary to the laws of political economy." In particular any interference with freedom of contract was supposed to offend against these laws. All, however, that economic science does with regard to freedom of contract is to explain what will happen if people are left free; and in some cases the obvious conclusion from the inquiry is, that in the interests of justice or morality or public expediency such freedom ought to be restrained.

Sometimes, it is true, this scientific attitude of economists is overstrained. In certain cases the only elements of importance are economic. Indeed, one principal meaning of economy is the least wasteful or most effective means to attain any given end, as, for example, when we speak of the economic employment of time, labour, or money. And yet, even in these cases it may sometimes be desirable on moral or social grounds to adopt the more expensive or less economical methods.

8. The Difficulties of Economic Studies. — The student must be prepared to meet with different kinds of difficulties in economics. Sometimes the object is to ascertain by a kind of Socratic induction the meanings of popular terms and the content of popular conceptions; or the difficulty may consist in a complete or adequate enumeration of details with a reasoned classification, *e.g.* in estimating the relative advantages of cultivation on a large

and on a small scale in agriculture; or, again, the strain of attention may be diverted to abstract principles which require for their development mathematical methods, as in most parts of the theory of value; sometimes the appeal to history is the main difficulty, as in considering the effects of the navigation acts or the origin of trade unions — and here the labour is increased if the historical is supported by the comparative method, as in tracing the development and decay of village communities; in certain parts of the subject we come in contact with the principles of jurisprudence and ethics, as in discussing the economic bases of private property or the laws of bequest and inheritance; and, finally, in the pursuit of descriptive and realistic economics, the student may have to contend on the one side with the facts of commercial geography, and on the other with the methods of statistics by which he will again be brought back to mathematical abstractions.[1]

[1] Cf. *Principles of Political Economy*, by H. Sidgwick, "Introduction"; *The Scope and Method of Political Economy*, by J. N. Keynes; *Introduction to the Study of Political Economy*, by Luigi Cossa (translated by L. Dyer); *The Elements of Statistics*, by A. L. Bowley; *Cours d'Économie Politique* (Tome 1), by V. Pareto.

BOOK I

CONSUMPTION AND PRODUCTION

CHAPTER I

WEALTH, UTILITY, AND CONSUMPTION

1. The Popular Conception of Wealth. — Political Economy is the science of wealth, and logically the first problem is to give a definition of wealth. Referring to the rules of definition, we may first take the definition of wealth which is the best known and most popular. "Wealth consists of all useful or agreeable things which possess exchange value; or in other words, all useful or agreeable things except those which can be obtained in the quantity desired without labour or sacrifice" (Mill). At first sight this seemed simple enough, but as soon as the definition came to be tested by particular cases all sorts of difficulties were discovered. Must the things be material? Is the wealth of a nation simply the aggregate of that of its individual members? Is the wealth of the nation to be measured by its exchange value? Is exchange value essential to national wealth? A vast amount of ingenuity was exercised in the discussion of these questions, and it became clear that wealth is a complex conception which demands a careful analysis.

2. The Economic Analysis of Wealth. — In the popular definition there are implied several distinct ideas each of which requires careful exposition; namely, utility, value, labour, and appropriation. That is to say, the things that are included under wealth are in general the result of

labour; they possess exchange value; they are appropriated; and in all cases they must possess utility. It is found, also, that in different departments and in different problems the emphasis is laid with varying force on these fundamental ideas. Thus, in consumption the stress is on utility, in production on labour, in distribution on appropriation, in exchange on value; whilst in dealing with economic progress and with the economic functions of government, the relative importance of these ideas varies at different points. It is not implied, however, that the attention is exclusively directed in production, only to labour; or in distribution, only to appropriation; and that in exchange, value alone is considered. Some writers make value fundamental in distribution, and in any account of value reference must be made to the agents of production, *e.g.* labour. In fact, it is only for scientific purposes that this logical separation of departments can be made. But logical separation of some kind is necessary for the scientific treatment of any complex phenomena. We may consider first utility and consumption, to which, since Mill, the attention of economists has been largely directed. It is now possible to present the main results in a simple form, though some of the deductions and applications are still open to controversy.

3. Utility and Disutility. — By the utility of a thing we mean its power to satisfy a desire or serve a purpose. To what extent this satisfaction is accompanied by pleasure or happiness, or is really beneficial to the individual or to society, are matters for special inquiry; but to begin with we need a term that is neutral or colourless. Utility in this wide sense lies at the root of demand, and there is no

doubt that, whether we consider individuals, or social classes, or a whole nation, there are extensive demands for things that are productive of misery and degradation. But these things to these people possess utility in the sense that they satisfy their desires. Disutility is simply negative utility. It thwarts the satisfaction of desires. Where utility causes pleasure disutility causes pain; where utility is beneficial disutility is injurious; in a wide or a narrow sense the one is the opposite of the other. It may be observed that throughout the whole range of economics this opposition is of importance.

4. The Relativity of Utility. — Although we speak of the utility being in the things, a little reflection shows that the term *utility* has no meaning except in reference to human beings. This is implied in the expression, *the satisfaction of desire.* It might be thought that practically the point is not of much importance. In the same way it may be said colours and other qualities of material things have only a meaning in reference to sentient beings, but for all practical purposes we may say the rose is red, and so on, without descending into the mysteries of psychology or metaphysics.

In the case of utility, however, this relativity is often of the greatest importance. The utility assigned to things is subject to all kinds of variations, and it is to the scientific examination of these causes of variation that much of the change in the statement of economic theory since Mill is to be ascribed. In particular, there is the distinction between *marginal* (or *final*) and *total* utility.

5. Economic Meaning of Consumption. — The object of

consumption is to satisfy desire. This simple statement needs no illustration; but, as is generally the case in economic conceptions, we easily pass from the obvious to the paradoxical. And the reason is the continuity of economic conceptions. Logically, we may class as consumable commodities all things that possess utility. Thus sunshine is a consumable commodity. It is true that it has none of the other marks of wealth; but, fortunately for human beings, many even of the necessaries which they consume are not wealth, though according to the old term they are *riches*.

The example of sunshine introduces another point. In some cases the consumption of things destroys wholly or partially their utility. But this is not always the case. Pictures may be gradually destroyed by time, etc., but not by being looked at, which is their real consumption. Houses are consumable commodities, and so are the lands on which they are built. The houses are gradually destroyed by consumption, but their sites remain.

6. Total and Marginal Utility. — As already stated, the utility assigned to or derived from things is subject to variation. Even when we consider the same individual and the simplest case of consumption, the utility is found to vary. To begin with, we may suppose that as consumption is increased desire is satiated, and in consequence less satisfaction is derived from further portions of the thing.

The utility derived from the last portion consumed is called the marginal (or final) utility. The aggregate of the utilities of all the portions is the total utility.

It is important to notice that the marginal utility is

not necessarily or even generally zero. On the one side, it may well happen that the consumer would gladly consume more if he could get it, and on the other, he may by excess pass through the zero point to disutility. As regards direct consumption (as distinct from the acquisition of commodities), the general rule is that, to begin with, for small amounts, the utility of the successive portions increases; then, after a certain point is reached, it continuously diminishes to zero, and then passes into disutility that also continuously increases. Consider, for example, the consumption of water — from a few drops to the torture of the Inquisition.

If disutility is involved, we must deduct the amount in estimating the total utility. Thus it is possible that the total utility may be negative. The fall in utility (after a certain point is reached) is often referred to as the law of diminishing utility and is best illustrated by a graph.[1]

The fall in utility refers to the successive portions and not to the aggregate utility. So long as the utility remains positive, the total utility increases, though at a lessening rate till the zero point is reached, after which the total utility diminishes as the disutility increases.

Even in this simplest case, that is to say, the direct consumption of an individual, there are certain questions to be answered (*e.g.* so long as any consumption is voluntary, can it be said to cause disutility in the sense defined?), but the real difficulties begin when we pass from the individual to the social group or the nation. And it may be noted that many fallacies have arisen in all parts of economics from supposing that what is true of an indi-

[1] See note appended to this chapter.

vidual in isolation is true of any number taken together. In general the transition cannot be made so easily.

7. Transition from the Individual to the Nation. — We may pass from the individual to the class and the nation in two modes. (1) The individual may be taken as a representative type. (2) By the aid of statistics we may construct an average. The value of the former plan depends on how far the case taken is fairly representative; that of the latter, on the way the average is obtained. In the first plan, if we simply assert that what is true of A is true of all people exactly similar, the statement is only formal. In the second plan we may, if the figures are given, estimate the consumption per head of the whole nation of all kinds of things; and, indeed, this is one of the most popular methods of estimating material progress. In England, for example, during the last fifty years there has been a great increase per head in the consumption of tea, sugar, etc. But we cannot say that any law of diminishing utility applies to this general (or per head) consumer. And in this connection it may be observed that the utility of the same things will depend on the way in which they are distributed, as well as on variations in the capacities of the recipients.

When we consider the variety of individuals of which a nation is made up, of all sorts of ages and capacities, it seems probable that the variations in the utility of consumption can only be estimated in the roughest and most indirect methods. These points, however, are best taken up in Book IV, which deals with economic progress.

8. The Measurement of Utility by Money — Consumer's Surplus. — In modern societies people make few things for

their own personal consumption, and in general must obtain their goods by purchase. Thus the utility of consumption is closely associated with the trouble or disutility of acquisition. We may suppose that any person regards the spending of money as involving in itself disutility, as in any case it deprives him of the pleasure of possession, etc. Thus we may say that a prudent consumer will try so to adjust his expenditure that in return for this disutility of expenditure he may obtain a maximum of utility.

It is easy to show theoretically (especially with the aid of graphs) that the expenditure should be so conducted that the marginal utility in each case is equal. If it is less in some case, too much has been spent on that thing; if it is more, too little.

It may also be shown that this final utility should at least balance the final disutility of expenditure.

As regards most incomes it may be supposed that the spender has a surplus of utility, and in some cases a very great surplus. Thus when we take into account the law of diminishing utility we see that the utility derived from the first portions of necessaries may be indefinitely great. But owing to the equality of prices the same price is paid per unit for each portion — for the first as for the last. Accordingly, if the last purchase just balances the loss of the money, all the former purchases must give a surplus. If we add together these gains, or these savings from what the man would have been willing to give, they constitute for *that* thing to *that* consumer what is called the consumer's surplus (or rent, on an analogy to be explained later).

Considering the limitation of incomes, it is possible that the last penny spent may yield a surplus. It is only when there is some money left over that the loss by the last penny will just balance the gain.

In any case, "We cannot speak of price measuring marginal utility in general, but only with reference to some individual purchaser" (Marshall).

It would seem, then, that the measurement of utility by money is something like measuring the heights of creatures in terms of their own feet. But then it may be replied that the standard foot is actually derived from this mode of measurement, and similarly of most measures they are connected with variable natural objects.

I have dealt with these difficulties elsewhere, and here I will only suggest that the advantages supposed to be measured by consumer's surplus, or rent, may be expressed in more general terms without any loss in precision.

Every person has a limited income, and in consequence, since the modes of expenditure and his desires may be considered as unlimited, he could always gain in utility by an increase of income. If, then, owing to any cause, some of the things which he ordinarily consumes fall in price (his income and other things remaining the same), he has more money to spend, and, just as by an increase of income, he can gain in utility. He may buy more of the old things, or better qualities, or new things. Or he may save the money for future needs. The real gains of increasing cheapness and plenty can only be estimated in a variety of ways; the nominal gain is the saving of money on the things formerly bought. It is sometimes useful, from the national standpoint, to compare the cost

of things at present prices (say the total imports) with the cost if prices had been unchanged.[1]

NOTE ON THE USE OF CURVES IN ECONOMICS — UTILITY CURVES

In the pure theory of economics the nature and relations of some of the fundamental conceptions can be most clearly shown by the use of curves. Curves of this kind intended for the illustration of abstract theories are always drawn with the proviso of hypotheses carefully laid down. They are not supposed to represent the results of statistical inquiries. For abstract purposes curves may be of great use when it is quite impossible to obtain the corresponding statistics. The principal use of curves of a simple kind is to illustrate in a graphical form the continuous variations in the quantity of one thing in response to changes in the quantity of another (or the connection between changes in the independent and in the dependent variable). Thus, as regards utility, the leading ideas and their interconnections may be represented by the following curves: —

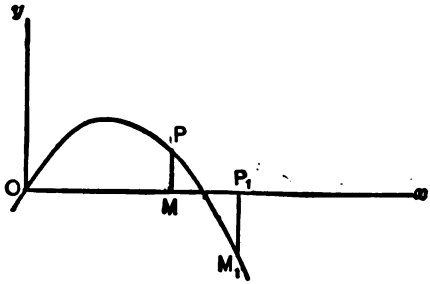


FIG. 1

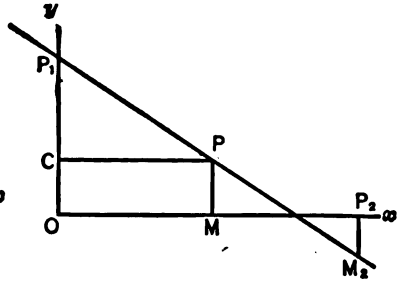


FIG. 2

Successive portions of the commodity are measured along *OX* and the corresponding degrees of utility along *OY*. In Fig. 1 for a time there is an increase of utility, but after a point is reached the utility begins to diminish and passes through zero into disutility — below the axis of *X*. This curve would illustrate the direct consumption of

[1] See Jevons' *Theory of Political Economy*; Wieser's *Natural Value*; Marshall's *Principles*, Book III.

a necessary, *e.g.* water by an individual. The utility of the first very small portions would be inappreciable to allay thirst or support life. In this curve it is of no importance how the utility is measured; the sole object is to show how the utility varies in response to successive units consumed. If P is a point on the curve, and a perpendicular PM is let fall on OX, then, if the consumption stops at M, PM represents the marginal utility; where the curve cuts OX the marginal utility is zero, and beyond this point it becomes negative, as in P_1M_1. The total utility is represented by the area bounded by PM, OM, and the curve; if PM becomes negative, the aggregate disutility must be deducted from the positive utility.

In Fig. 2 we may suppose, as before, that units of the commodity are measured along OX and the corresponding utilities are measured along OY by the prices that would be given for successive portions. To a single consumer the utility may be supposed to be measured in this way. Any price higher than OP_1 is to him a prohibitive price, and after this point he will give less and less as his desire decreases. We may suppose that he will cease his purchases of the commodity in question at the Mth portion, when the market price as determined by outside agencies is PM. If the market price were to rise, he would buy less, and if it fell he would buy more. But in any case his marginal purchase would depend partly on what he could do with the money if not spent on this thing. The only advantage of bringing in money at all is as a measure that can be applied to other things. If for every portion he is only obliged to give PM, the market price, while he would be willing to give more for each portion up to the Mth, he makes a gain or saving on these portions, and the aggregate may be called consumer's surplus. This would be represented by the area P_1CP.

P_2M_2, considered as a negative price, would mean that he would pay something to get rid of the thing.

The abstract nature of the reasoning is seen when we consider that the continuity of the curve implies that both quantities and prices move by infinitesimal gradations. An approximation is made to reality by Professor Marshall in taking the consumption of a large market and adopting the device, to begin with, of thin parallelograms passing into thick straight lines (*Principles*, 4th ed., p. 203 n.). The assumptions given by Professor Marshall must be carefully noted.

[On the use of curves the student may consult Wicksteed, *Alphabet of Economic Science;* Pantaleoni (translated), *Pure Economics;* Jevons, *Theory of Political Economy;* Pareto, *Cours d'Économie Politique* (Tome 1, Introd.). Most English readers will probably find the footnotes in Marshall's *Principles* the most satisfactory introduction, and for advanced treatment the Appendix of *Mathematical Notes;* Edgeworth's *Mathematical Psychics* is a work full of ideas.]

CHAPTER II

PRODUCTION AND THE AGENTS OF PRODUCTION

1. Meaning of Production. — The definition of the terms *productive* and *unproductive*, as applied to labour and consumption, was the occasion of one of the most prolonged controversies in economics, a part in which was taken by all the leading economists from Quesnay and the Physiocrats to Mill. And even now traces of the difficulties which were so hotly discussed are found to survive. It would be most instructive to trace the development of the controversy, which is one of the best instances of the necessity of examining carefully the meanings of terms in popular use. For the reasons already given, however, the history of economic thought must be passed over.

Eventually, it became clear, as was pointed out by Mill, that the terms *productive* and *unproductive* can only have a meaning in reference to some correlative. Productive must mean productive of something. What is that something? The appeal to popular usage gives a vacillating answer; so also does the appeal to the authority of economists. Mill thought the correlative ought to be wealth; but this answer only leads up to all the difficulties involved in the definition of wealth itself. The only plan, then, seems to be to give the meaning that is best adapted to the exposition of economic conceptions.

Production, then, may be defined as the production of

economic utilities; those, namely, which in general are the result of labour, possess exchange value, and are appropriated (which may be taken as the definition of wealth so far as that is possible).

If we substitute for wealth the expression *economic utilities*, we get rid of many vague and inconsistent ideas popularly associated with the term.

In any case it is convenient to consider separately what, for brevity, may be called material and immaterial production.

Material production simply puts utilities into material things or adapts them for consumption. The principal point to notice is that the corresponding utilities may be of the most varied kinds. Thus transport puts in the things the utility of being in the place where they are wanted; so also do wholesale and retail trade. "The act of production is not complete till the commodity is in the hands of the consumer."

Similarly, it may be argued that the mere appropriation of land or other agents is, in a sense, economic production. History shows very clearly that production in the narrow sense cannot go very far until the utility of being appropriated is planted in the things. Thus it is often argued that the appropriation of land was essential to the disappearance of slavery, which is the most wasteful of all forms of labour, and any economy of labour is equivalent to an increase of productive power.

In *immaterial* production we have, first, the utilities fixed and embodied in persons, *e.g.* forms of technical skill; secondly, the ideas that find expression in art, science, and literature; and lastly, personal services.

Even in the earliest societies it is observed that some utilities are only possible with associations of individuals, and the varied utilities of organisation become of more and more importance with the progress of society. The building up of a system of banking and credit, which in the last resort must be reduced mainly to mental elements, is as necessary to economic production in general as the development of the material means of transport. Similarly education, both of individuals and of groups, is as essential as the exploitation of natural resources. The importance of the immaterial factors of production was admirably brought out by List, whose work on the *National System of Political Economy* may be taken as a corrective to the popular system derived from Adam Smith, though his critique of the real Adam Smith is often unfair or exaggerated.

2. The Agents of Material Production. — It is commonly said that there are three great agents of production: namely, land (which is taken as representative of nature and natural resources generally, and thus includes water), labour, and capital. Some have denied original rank to capital on the ground that it is derived from the other two. But this objection seems to carry the analysis too far. In the same way nature might be held to include human nature. In the earliest times we find that all the essential forms of capital are of importance in production. In prehistoric times many of the most important aids to production were discovered: *e.g.* taming of animals, working in metals, boat-building, weaving, ploughing, etc. That is to say, we find examples of capital in the sense of wealth, auxiliary to labour. We also find examples of

sustaining capital which enabled primitive man to "wait" for distant returns, and of those relatively permanent sources of utility that modern analysis classes as consumption-capital. Through the whole range of economic history we find that the possessors of production-capital were able to obtain some revenue for its use. In the village community those who provided the various parts of the great plough and the oxen had shares of the produce in return, just as the driver of the oxen had for his labour.

Some writers have added to the three agents another under the title of organisation. And unless the term *capital* is extended so as to cover this agent, the addition seems to be justified.

3. Nature. — Nature provides materials and powers. In all forms of material production there is only the adaptation for man's use or consumption of what is given by nature.

The question was much discussed, in connection with the controversy on the meaning of the terms *productive* and *unproductive*, whether nature assists more in some things than in others; but it is now only of historical interest, especially in connection with the development of the theory of rent. It illustrates forcibly the difficulty of attaining clear ideas in economics, and the necessity of examining the terms already familiar. With us it is difficult to enter into the real meaning of these old controversies, but that they were real is shown by the practical proposals to which they gave rise, *e.g.* the single tax. Here all that can be noted is that the study of the development and decay of the Physiocratic doc-

trine and of its influence on thought is well worthy of attention. Any short summary, however, is apt to be misleading.

Of the gifts of nature some are practically unlimited, others limited. The division is relative to the numbers of the people and to the degree of civilisation they have attained, both as regards the desires for consumption and the arts of production.

In considering the productive powers of different nations, or of any one nation at different stages of its development, the influence of natural conditions is always of importance in several ways. This is a topic in which the details must be filled in by reference to economic history and to commercial geography. Here little more than the basis of classification can be given.

The chief points for consideration and inquiry may be classed under the following headings: climatic conditions, including the mean temperature and the extremes and variations of heat and cold, force and direction of the winds, healthiness or the reverse. The great trades of the world depend largely on these differences, as also do variations in the efficiency of labour.

The geological character of the country must be taken in various aspects, *e.g.* as regards coast line and natural harbours, mountains and plains, fertility of the soil, and supply of minerals and raw materials. The discovery of gold or coal may in a few years transform a country. The water supplies are of importance: as regards the means of communication, the necessity of elaborate drainage, or providing motive power.

The situation of a country relatively to others may

under different conditions be the dominant factor in the supply of its wealth, — as is shown in the history of the transference of commercial supremacy.

When we put all these influences together, we see that even the most highly civilised nations under present conditions depend largely on these natural conditions. To take one example, the present industrial prosperity of Great Britain depends to a great extent on its moist and temperate climate, its coast line (no place being far from the sea and natural harbours), the suitability of its soil for various agricultural products, its coal and iron, its navigable rivers, and, finally, its geographical position.

At the same time, natural conditions are not always of predominant importance, as is shown both by history and by the present state of nations.

4. **Labour.** — The importance of labour is so great that it appears through the whole range of economic inquiry. At this stage only the meaning will be investigated. Labour must always be considered from two points of view, which, for brevity, may be called subjective and objective, — more popularly, from the point of view of the feeling of the worker, and from that of the work done.

As regards the subjective meaning, most economists have assumed that labour is essentially painful, or, more generally, involves an element of disutility. This view is often too narrow, and the socialists have done good service in pointing out that, with a proper distribution of work, and under good conditions, labour may well be directly productive of enjoyment. Most people in full health need regular exertion, and the fact that they earn money by it, as in their regular work, need not destroy

the pleasure of the work itself. At the same time, it may be admitted that the continuous steady work which is necessary to keep the national production at full pressure involves a strain and a sacrifice of freedom which will only be submitted to in the hope of an adequate reward.

In a general view of economic labour it is best to begin with a survey of the elements involved in a "quantity of labour" from the subjective side. The expression is to be taken in the sense given to it by Adam Smith in a celebrated passage.

Under this term are included all those influences which affect the minds and the lives of the workers in doing the work. Such are : —

The time involved. At first, time may be taken as uniform, *e.g.* five times as much labour in five hours as in one, but after a point there is a rapid increase in the quantity of labour, *e.g.* the twentieth hour of the man in the signal box.

The next point is the intensity of the labour. "There may be more labour in an hour's hard work than in two hours' easy business."

Logically we ought to include in the real cost of the labour (which is another name for this subjective quantity), not only the prime cost, but also the supplementary cost in the way of education or preparation. "There may be more labour in an hour's application to a trade which it cost ten years to learn, than in a month's industry at an ordinary and obvious employment." We must also take account of the environment of the worker: the physical and sanitary, as well as the mental and moral conditions under which the labour is performed.

Finally, it may be said that the unit of time ought to be the whole life. Statistics of the different employments show that the conditions of work have an effect on the duration of the power to labour, and anything that shortens life must be held to intensify the labour, though it may not be perceived at the time.

When we regard labour from the *objective* point of view we are mainly concerned with the causes affecting the efficiency of labour. These may be divided into two groups: those affecting the individual, and those affecting combinations of labour. At this point only the former need be considered.

Such are qualities of race and the influences of heredity, of great importance, but liable to be exaggerated. The supply of food, or more generally of necessaries, is sometimes an essential factor, as in the "economy of high wages." On this point, the change of opinion is remarkable; it used to be accepted doctrine, that, the less people had, so much the harder they would be compelled to work, *e.g.* that they would work harder in dear years. Lately the exaggeration has been toward the other side in many cases. To revive an old term, all consumption is not productive, or, in other words, does not add to efficiency. The full treatment of this topic would involve an elaborate inductive inquiry.

The environment affects, not only the feelings of the worker, but also his efficiency — and in many ways.

The intellectual ability, natural and acquired, involves, for adequate treatment, an examination of systems of education. The opinion may be hazarded that, at present, too much stress is laid on direct technical training.

Similarly, the moral capacities and activities operate on the effectiveness of the worker in a great variety of ways. As an illustration on a large scale, we may take the gradual transition from slavery through all degrees of serfdom up to free labour. There is no doubt that one of the principal agencies in this transformation was the increasing efficiency of labour with increasing freedom. In conclusion, it must be laid down with the greatest emphasis, that labour, as an agent of production, must be held to include the very highest professional skill of all kinds, as well as the labour of unskilled workers and artisans; we must include, not only the labour of those engaged in business in the ordinary sense of the term, but that of those employed in education, in the fine arts, in literature, in science, in the administration of justice, and in government in all its branches; and we must include also, not only the labour that results in a permanent form, but also that which renders services that perish in the act.

Since the time of Adam Smith (who took a very wide view) there has been a tendency to narrow unduly the interpretation of the term *labour*, and in that way to take a limited view of the range of economic inquiry. At present there are problems connected with the expenses of education, and the expenses of defence, which, to say the least, are as important as the actions of trusts and trade unions; and one essential part of these problems is the training of the individuals. Even under modern conditions, with our large-scale methods, in the last resort the economic unit is not a corporation or an army, but a man.

5. **Capital.** — Capital, like labour, is dominant in every department and has also an endless variety of forms. On the meaning and the functions of capital, volumes have been written, and, to judge by the economic journals, volumes are still being written and no doubt will continue to be written. Properly viewed, this is not a matter for regret, as it simply indicates that capital is one of the most far-reaching conceptions, and that with changing conditions its content is subject to change (as soon as we leave generalities). The present section must be regarded as an introduction only, to the study of these generalities and this brief treatment must of necessity be selective and dogmatic. In its origins (or one of them) capital means the principal in a loan of money (*capitalis pars debiti*) as distinct from the interest. Gradually, though many chapters of economic history are required to trace the details of the process, it became clear that not only money, but anything that yields interest, ought to be placed under capital. Money itself only yielded interest by being employed, and the interest was earned by other things.

Thus the conclusion is reached that it is of the essence of capital to yield a revenue. This is the root idea with Adam Smith and still may be considered as prominent in popular discourse.

This idea of yielding revenue is generally the most important from the point of view of the individual. A person will class as capital the loan advanced to an unproductive landlord or an extravagant government, so long as his fund is secure. If the revenue is forthcoming, the capital from his point of view is always there; and if

the revenue ceases with no chance of renewal, the corresponding capital disappears as a bad debt.

But especially when we look at capital from the national standpoint, we have to consider how the revenue is obtained. A nation considered as self-dependent cannot make a revenue unless its resources are employed productively; a nation of money-lenders would soon realise the barrenness of money. Seeing, then, that the revenue of capital must be produced, some writers have found the essential character of capital is its productiveness. And if a nation begins to consume its capital without replacing it by production, it must sink into poverty. As its capital disappears so also will its income. This is self-evident, if capital is one of the fundamental agents of production, and in one sense at least it must be so regarded. It seems best, however, to emphasise the idea of revenue from the individual standpoint. But in some respects this idea also needs modification or supplement. If, to begin with an example, a dwelling-house is to rank as capital when let to a tenant for a rent, then it must also so rank when occupied by the owner (and by the severe logic of the British income-tax gatherers, even when not occupied). This leads up to what may be called *consumption*-capital in the specific sense of the term. This form of capital (or capital from this point of view) consists of things which yield utility, not in the shape of money revenue, but in some form of direct enjoyment or satisfaction. Take, for example, the movables in the houses of individuals, and the forms of public property, such as picture galleries, museums, etc. This class of wealth, by whatever name it is called, is of great impor-

tance. Sir R. Giffen, in his calculations of the capital of the United Kingdom, reckoned the movables in the houses as of about half the value of the houses.

Thus, on this line of treatment, there are three great species of capital; namely, *production*-capital, *revenue*-capital, and *consumption*-capital.

If now it is asked: Is there any root idea common to these three species? it may be said to be found in the satisfaction of future needs, as contrasted with present and immediate consumption. Even in the last species named, *i.e.* consumption-capital, things are not included unless they are designed for future as well as immediate use. Thus, in this view, the relative permanence of capital is contrasted with the relatively immediate consumption of income. "Prospectiveness," not productiveness, is in this way the most general characteristic of capital, if only one term is to be employed.

There can be no question that one of the best signs of national progress is the growth of this power of looking to the future, and either directly by the creation of consumption-capital, or indirectly by that of means of production, giving effect to this idea of "prospectiveness."

For some purposes, however, we have to specialise, and besides the species of capital already considered there are others.

Recently some economists have insisted on a general view of capital that at first sight seems directly opposed to that just presented. It is said that the distinction between capital and income is simply a difference in the modes of measuring wealth, whether of individuals or of nations. The capital of an individual or a community is an amount

of wealth in existence *at* a particular moment, while the income is wealth obtained *during* a certain period. To the present writer this view of capital seems rather adapted to accounting than to economics. The mere valuation of a nation's wealth at any particular moment, if it could be effected, would be of no interest except as the basis of comparison with a similar estimate at some other date; and the comparison for economic purposes would be of no use without analysis, and such analysis would bring out the ideas already examined.

When *production*-capital is examined, several species are discovered. Circulating capital "fulfils the whole of its functions in a single use, *e.g.* raw materials or necessaries for labour" (Mill); fixed capital can be used in production more than once without losing its form. Adam Smith defined circulating capital as that which yields a revenue by circulating or changing hands. Perhaps the most interesting point in Adam Smith's treatment is that, in spite of his realism and popular style, he is led by the stress of his argument to use the term *immediate* as possibly covering generations and to rank buildings as capital only when they yield a revenue, not only to the owner, but to the occupier, — another striking instance of the difficulty of adapting popular ideas and language to scientific purposes.

Mill's four propositions on capital (in his sense of production-capital) are of interest in the development of economic thought. With the exception of the unfortunate fourth, — demand for commodities is not demand for labour, — they are taken from Adam Smith. So far as true they simply assert that capital (in Mill's sense) is

a necessary agent of production and that it is being continually destroyed (Mill says consumed) and reproduced. These propositions are of interest in connection with the wages fund theory, and of use in disposing of certain crude fallacies on the nature of saving and the powers of governments.

6. The Connection between Consumption and Production. — At this point attention may be called to the old distinction between productive and unproductive consumption. Only that consumption was classed as productive which was necessary to the efficiency of labour and keeping up the supply of labour for productive purposes. Thus not all the consumption even of the most poorly paid labourers was productive. Carried to this extreme, the distinction proved to be of little value, and the point involved is better treated under the causes affecting the efficiency of labour.

Generally, it may be said that consumption means using things, and production means adapting them for use; and logically the two ideas are better kept distinct.[1]

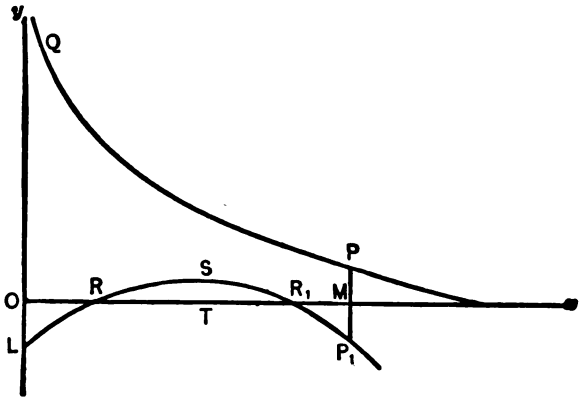
Note on the Curve representing the Quantity of Labour and the Utility of the Product[2]

Along OX measure units of time devoted to labour. At first there may be some disutility OL; this gradually decreases and passes through the zero of indifference R to positive utility corresponding to the moderate pleasure of active work RSR_1. After a point T on axis

[1] See Higgs, *Physiocrats;* Mill, *Principles*, Book I; Marshall, *Principles*, Book II; Boehm-Bawerk, *Capital and Interest* and *Positive Theory of Capital;* Cannan, *Theories of Production and Distribution;* Smith, *Wealth of Nations*, Book IV, Chap. IX.

[2] See Jevons, *Theory*, p. 168.

the utility diminishes and passes through zero R_1 to disutility, which rapidly increases; this corresponds to the excessive fatigue of overwork.



QP is the utility curve which represents the utility obtained from the product of the successive units of time devoted to labour. The first portions may be supposed to provide for necessaries, and the utility is indefinitely great, but after a point the utility diminishes. It will pay the worker to continue up to the point at which the utility *PM* obtained in return for the last unit of labour time is just equal to the disutility P_1M involved. Up to that point there is a gain of utility, but after this point there is increasing disutility. It will be noted that the curves are only intended to illustrate the general relations between labour (subjective) and the utility of the result.

CHAPTER III

DIVISION OF LABOUR

1. Meaning of Division of Labour. — Like other economic terms of popular derivation, division of labour embraces several distinct but allied conceptions. Briefly stated, it includes the division or specialisation of employments within a nation, and of processes within an employment. This division again involves combination and organisation, including exchange. The expression *division of labour* was used by Adam Smith in the widest sense, although to begin with he takes the simple case of pin-making, and in consequence is often supposed to use the term only in the most special and narrow sense.

As showing the importance of both aspects, it may be recalled that Mill entitles the corresponding chapter *combination of labour*.

In any case it is found that division of labour involves a corresponding division and combination of capital — both material and immaterial.

The separation of employments is of very early origin, and is well illustrated by the industrial offices of the village communities. But in these self-sufficing communities only a very limited division of employments was possible. To get the benefits of this separation to its full extent, a large nation and even the whole commercial world is required. Thus it is sometimes said that free

trade is an example of the advantages of division of labour: the productive powers of each country are devoted to what it can best produce.

Division of labour in the narrowest sense refers to the separation of processes within any particular industry or employment.

2. Advantages of Division of Labour. — The advantages commonly enumerated, following Adam Smith, are: The increased dexterity of the workers through constant practice of the same thing. This may be illustrated from primitive times in the skill shown in making the serrated edges of the flint arrows. But the full power is only seen when taken with the appropriate auxiliary capital. In all the higher forms of labour such specialisation seems necessary to success. This advantage appears most in improvements of quality rather than in economy of productive power. In both respects labour has to compete with machinery. On the whole, however, contrary to popular opinion, the development of mechanical appliances since the industrial revolution has increased the skill of the individual workers, or, what is the same thing, this increased division of labour demands greater skill.

Under a system of minute division of labour the various workers can be classified according to their several capacities, and full employment can be given to the auxiliary capital. This can be illustrated indefinitely by reference to the employment of men, women, and children, in each case with great varieties of skill.

There is an economy of time; *e.g.* no waste in passing from one form of work to another and in starting different operations, in early times a point of much importance.

Under present conditions the time element is chiefly of importance in cases in which the work could not be done in the time required without division of labour.

The continuous specialisation promotes the discovery of inventions. No doubt, as is shown by history, the original creative idea may often be due to outsiders; but the full development for practical purposes is only possible by little increments of invention. In material production it seems that progress is more continuous than in other departments of human activity, *e.g.* literature and especially poetry. It is rarely that improved processes of production are lost and the beginnings of most of the industrial arts can be carried back to prehistoric times: the dug-out canoe is the forerunner of the steel iron-clad.

In any of its varied meanings division of labour involves a corresponding specialisation of auxiliary capital. And for this purpose capital must be taken in the most extensive sense. Thus we must include the mental capital of the nation and of the world as exemplified in the various practical sciences, such as chemistry, engineering, etc.

The combination of labour is of two kinds: simple and complex. In simple combination the advantage lies in numbers doing the same thing at the same time; *e.g.* in the harvesting of primitive communities or the navigation of a great ship in modern times. The latter example also serves to illustrate complex coöperation, which is still better shown in the building of the ship. Here the idea is that numbers of different operations are combined to produce a complex result. In some cases we have a com-

bination of labour extending over generations, as in the construction of vast systems of drainage.

The advantages of division of labour have, up to the present, been realised to a greater extent in material than in immaterial production; and the progress of the speculative, as distinct from the practical, sciences would be greatly promoted by more systematic organisation.

3. Division of Labor is limited by the Extent of the Market. — Division of labour involves, as a rule, production on a large scale, and this again depends on the extent of the market. Thus an increase of foreign trade by rendering possible production on a larger scale may cheapen the commodity in the home market. At present, aided by protective tariffs and trusts, this advantage is often transferred to the foreigner. The course of English economic history shows very clearly the influence of the growth of foreign trade on the development of industry, *e.g.* at first in woollen manufactures and later in cotton.

Theoretically it might be advantageous to give bounties on production if the economies of division of labour could be introduced to such an extent that they would more than compensate for the payment of the tax.

In immaterial production also the division of labour is limited by the extent of the market; *e.g.* in law, medicine, education, and the various professions the greater the demand (or the market for the corresponding services) so much greater is the specialisation. A good example is found in banking. It is thus clear that division of labour is closely connected with exchange, and this forcibly illustrates the interconnection of the great departments in economics. Exchange, again, involves the protection of

property and the enforcement of contracts and generally security. In this way division of labour is also connected with distribution and governmental control. Finally, it may be said that economic progress is to a great extent dependent on the development of division of labour, and there was good reason why Adam Smith should make this principle the starting-point of his inquiry.

4. The Localisation of Industry. — The localisation of industry depends partly on the specialisation due to division of labour. It is one of the most interesting problems in economic history to trace the reasons why certain industries have become settled in certain localities. To begin with, there may be some natural advantage, *e.g.* proximity to the source of materials or powers provided by nature; political or social influences may create a local demand; and in certain notable cases in English history there have been settlements of foreign artisans, sometimes attracted to this country by the hope of gain, sometimes driven from their own by political or religious persecution. Again, protection may stimulate production in certain places, and in the mediæval period the towns adopted a protectionist policy against one another.

At this stage, however, it is more important to observe that, if for any reason an industry has once been established in any locality, there are strong reasons why it should continue to flourish there and not be transported to other places. Both labour and capital become specialised and there is a continuity of improvements; industries grow up that are subsidiary to the main industry; the means of communication are adapted both to the acquisition of raw materials and to the marketing of the products;

in short, there are all the internal and external economies of which Professor Marshall has given so full and lucid an account.

Too much stress, however, ought not to be laid on these initial advantages, and in general any attempt at monopoly has been defeated. The restrictive policy of the old gilds and corporations was a failure. Just at the very time when, owing to a variety of causes, the economic system of the Middle Ages was giving place to the modern, and England was entering on a period of prosperity, we find constant complaints of the decay of the towns and of their staple industries. The chief reason was that the industries were migrating to the county districts, where they were free from these monopolistic restraints. In the same way, in modern times, protection has often failed to neutralise foreign competition.

The principles and the progress of localisation are also exemplified in the case of immaterial production. Universities and law courts remain settled in certain places, and banks and credit institutions once established may retain their position, though it would seem that other places have greater advantages. Here also, however, the initial advantages cannot be maintained unless there is continuous adaptation to the progress of society.

5. Disadvantages of Division of Labour. — When the disadvantages of division of labour are spoken of, it is not meant that they are such as are necessarily inherent in the system, but only such as experience has shown are likely to occur and ought to be guarded against. Such disadvantages arise from the excessive specialisation of the individual, from the concentration of labour in large facto-

ries and in cities, and from the delicacy of the industrial organisation. In a general survey these disadvantages may be classed in three groups; namely, physical, mental, and social. It was observed by an Italian writer, early in the eighteenth century, that particular physical diseases are associated with certain employments. Under modern conditions this liability might be indefinitely illustrated, and a large part of the factory legislation is intended to provide a remedy for these abuses. In fact, it may be said that there is hardly any great industry which is not subjected by law to certain compulsory sanitary regulations. It is, however, a curious fact that the workers themselves often place obstacles in the way of efficient inspection and of the discovery of the infringement of the acts. In the matter of the relative healthiness of employments the only safe rule is to appeal to experience. Thus coal-mining, apart from the liability to accidents, is a healthy employment, whilst very often out-of-door occupations, owing to special circumstances, are relatively unhealthy.

More stress has been laid on the mental evils that spring from excessive specialisation than seems to be warranted by facts. Here the principal evil alleged is the monotony of the work, which is supposed to have a cramping effect on the mind. This has been forcibly brought out by Adam Smith. In an eloquent passage he contrasts the driving of horses with the driving of machinery. So much was he impressed by the evil of monotony that it was one of the chief grounds why he thought the education of the common people demanded the special attention of the state. In modern times the evil has been denounced with still greater eloquence by Ruskin, though the eloquence

is marred in his case by ignorance of economic facts and principles. Perhaps the difficulty is most forcibly put by the French writer who asks what can be expected of the mind of a man whose activities are constantly devoted to making the eighteenth part of a pin.

In this argument, however, it is assumed too readily that the minds and characters of men are moulded entirely by their occupations. But it should be remembered that the very monotony of the work saves the energies of the individual, and in his leisure he can do something better than merely satisfy his physical wants. Thus the operatives of Lancashire are devoted to music. Many cases are recorded in which a factory hand has come to the front through educating himself in his spare time; but spare time without spare energy is worthless. It is remarkable also, in the highest branches of labour, how often the workers find relaxation in different pursuits. At present it may be said that the sports and the habits of the masses of the people have more to do with mental narrowness than any monotony connected with their work.

The monotony itself is also liable to be exaggerated The more monotonous the work, so much the more probable is it that there will be a substitution of machinery for labour.

Again, as regards the evils attributed to the cities compared with the country they are liable to be exaggerated. In the past freedom began with the towns, and in one of his best chapters Adam Smith has described how the commerce of the towns led to the improvement of the country. In modern times it is too readily assumed that the immigration from the country to the towns is in every case due to a want of correct judgment on the part

of the immigrants. But the cities offer their gains as well as their losses, and class for class the workers in the town will compare favourably with those in the country. When we look at the broad facts of progress, we find that, on the whole, the modern system, with its complicated machinery and its use of scientific methods, involves a much higher development of the race than was possible under simpler conditions. In the Middle Ages there were artists and men of genius, and some of the most wonderful personalities the world has ever seen. But the mediæval serfs who formed the bulk of the population were under less favourable conditions for development than the lowest labourers of the present. But for the progress of cities and manufactures England would have remained as backward as Russia.

At present, also, it is in the employments in which there is least division of labour and the greatest survival of older and simpler methods that there is as a rule most misery, *e.g.* the workers on canal barges, the nailers in Staffordshire, and generally those engaged in what are called the domestic industries.

The social disadvantages that arise from the delicacy of the industrial organisation, the interdependence of industries, the oscillations between periods of inflation and depression, excessive competition, and the sudden action of the "law of substitution," are to be ascribed, not only to division of labour, but to other forces and conditions that fall to be considered in other departments of economics.[1]

[1] On special topics in this chapter, for fuller treatment, see Nicholson, *Effects of Machinery on Wages;* Hobson, *Evolution of Capitalism;* Cunningham, *Alien Immigrants into England;* Marshall, *Principles of Economics*, Book IV, Chaps. VIII–X.

CHAPTER IV

PRODUCTION ON A LARGE AND SMALL SCALE

1. Production on a Large Scale in Manufactures. — The tendency to production on a large scale consequent on the extension of division of labour and the associated auxiliary capital (material and immaterial) is best treated by taking different typical cases separately — and first, manufactures. Here the concentration of labour and capital and the amalgamation of small industries has been most noticeable since the industrial revolution, and quite recently a further development has taken place by the creation of trusts. The process of concentration can only be explained adequately by an inductive inquiry, and here it is only possible to give an outline of the lines to be followed.

The efficiency of the productive agents is greater in many ways in large production, *e.g.* there can be a better classification of labour according to its capacity; applied machinery can be so adjusted as to give full employment to the motive power; improvements can be more readily adopted; small inventions can be encouraged; expert skill can be called in to a greater extent; better agents can be employed in the selection of materials and of processes; and the control of departments and subdepartments can be put in the hands of competent managers while the energies of the head of the firm are devoted to general superintendence and organisation.

A variety of internal and external economies (Marshall) can be adopted in large scale production, the details of which vary in different cases and can only be enumerated in special works.

2. Other Cases. — The tendency to large production is also shown in a pronounced manner in the means of communication and transport. The history of railways, of shipping, and of telegraphs is the history of amalgamations.

Similarly the distribution by the wholesale and retail merchants, which logically is part of production, has followed the same lines.

Mines are worked by larger capitals, so are gas and water companies.

The same tendency also appears in various forms of immaterial production. Thus joint-stock banks have swallowed up the private banks to a great extent, and the larger insurance companies have displaced the smaller.

In fact, when we take a rapid survey of the history of the nineteenth century, the tendency to large scale production becomes so prominent that it seems to give a basis to a universal law or generalisation.

Of late, in particular, the spread of the trust system has induced the fear that in the course of time there will be no small industries left, and that the industries of all the great nations will be concentrated in the hands of a number of gigantic trusts. Thus it is important to consider the counteracting causes.

3. Counteracting Causes. — The localisation of industries renders it possible in some cases for a number of relatively small businesses, that specialise in certain branches, to succeed as well as if the processes were carried on by

the same firm. The loss incurred in small economies may be made good by the greater specialised skill on the whole.

Again, to all large industries there are subsidiary industries which provide certain things only required to a small extent or occasionally. Thus there may be a variety of trades in the hands of small masters.

In the course of progress new wants arise that are met by new luxuries. Very often these are of such a kind and of such variety as to be best produced on a small scale, *e.g.* photographs, scientific instruments, etc.

The force to be attributed to these and other counteracting causes can only be properly estimated by an inductive and historical inquiry beyond the limits of these pages. But as the point is at present of much interest, a few significant figures may be quoted from a recent investigation by Leroy Beaulieu. He shows that in the British textile industries there were in 1896 as many as 9891 factories belonging to 7900 firms compared with 5961 factories in 1870. In France the *patentes* or taxes on businesses have grown steadily from 1,163,255 in 1830 to 1,752,345 in 1900, and the population is far from having grown in the same proportion. This growth of small industries is explained by a variety of causes: industrial operations formerly done at home are now specialised, and give rise to small industries, *e.g.* laundry work and baking; brokers and middlemen, though displaced in some directions, have been more than proportionately increased in others; and many of the recent inventions have favoured the growth of medium businesses — such as those connected with electricity and the manufacture of bicycles, and even of motors. Wealth and luxury, being

more general, have called into existence numerous small industries for the production of *articles de luxe*. "There has been quite a swarm of new small and medium industries" — is the general conclusion.

Much attention has been recently directed to the fact that in the United Kingdom there are registered every year a large number of joint-stock companies with relatively small capitals. This is the more noticeable because it is generally supposed that the chief inducement to joint-stock enterprise is the magnitude of the capital required.

4. Joint-stock Companies. — The economic history of companies is of the highest interest, and for the origins we must go back to the mediæval period. Joint-stock companies proper were preceded by various forms of organisation, notably regulated companies, but the joint-stock principle proper was well established in the seventeenth century.

The speculative manias that arose in France in connection with the schemes of John Law, and in England with the South Sea Bubble, and the little success that attended the foreign trade companies, gave rise to a general distrust of the principle, as is shown by the increasing stringency of legislation. Adam Smith himself was so much impressed by the facts of history, that he maintained no company could hope to succeed unless it had a monopoly, or was such that its business was of a purely routine character. In support of this narrow view, he emphasised the want of self-interest on the part of the managers and the tendency to the neglect of small savings. These difficulties, however, have been obviated to

a great extent by the encouragement of professional skill, by gradual promotion to valuable appointments, and by giving a certain interest in the business to the employees. Profit-sharing, however, has not succeeded to the extent that might have been expected.

The advantages of joint-stock companies are: they can undertake operations too large for private enterprises, *e.g.* railroads; in some cases they can offer the security of a larger reserve fund, as in banks, in which, even if the liability is limited, there is generally a large uncalled capital; in companies generally there is greater publicity as regards the accounts, and thus so far greater security in credit transactions; they serve for the investment of small savings, and thus provide also for the distribution of risks; they can afford to work for lower gross profit as the shareholders only expect a fair return in the shape of interest, and not profits of management; conversely, where the risks are great, but the chances of gains are also great, a company may be floated where private enterprise would be repelled. The adoption of the principle of limited liability has given a great stimulus to companies.

The resultant effect of these and of other influences of a more special character in different circumstances, has been that companies have displaced to a great extent private enterprise in many important industries. As already observed, however, many of these companies are relatively small, in fact, in some cases, so small that it may be supposed that the principal inducement has been the limited liability. From a recent return (1902), to the income tax assessments in the United Kingdom it

appears that, of over 25,000 public companies, less than 5000 earn more than £5000 per annum, whilst more than half of the total number earn less than £1000 per annum.[1]

[1] See Marshall, *Principles*, Book IV, Chaps. XI and XII, Book VI, Chap. VII; Macrosty, *Trusts and the State;* S. and B. Webb, *Industrial Democracy;* Hobson, *Evolution of Modern Capitalism.*

CHAPTER V

PRODUCTION ON A LARGE AND SMALL SCALE IN AGRICULTURE

1. Complexity of the Question. — In comparing the relative advantages of large and small farming, there are several distinct questions involved. Besides the question of production pure and simple, there are various social and moral factors, which it is difficult to keep separate in any particular case.

If we confine the attention only to production, the question becomes: under which system will the efficiency of labour and capital, when applied to land, be the greater?

This implies that equal amounts of the productive agents are compared. One favourite argument, however, in support of the small system is the greater ardour of work, the long hours, the devotion to the land, etc; and on analysis this surely implies that more labour is applied, and so far there should be a greater return. And then the further inquiry should be made: what might be done with this labour if devoted to other pursuits? Thus, in the Highlands of Scotland, an amount of labour is often spent on the small crofts which would give a far greater return if employed in fishing, or in work on the larger farms. More generally, the growth of towns and the advance of civilisation has been only possible by the transfer of labour from the land.

Again, when dealing as far as possible with production merely, there is still the difficulty of the measure to be adopted.

We can only compare different kinds of produce by estimating the money value of the returns. And then from the national point of view the question arises whether we ought to take simply the net return, or the gross yield. In practice the net return would be the rent. It is clear, however, that the maximum rent in some cases might be yielded with an insignificant amount of gross produce, as when a large tract of country, formerly cultivated, is thrown under deer. The rental may rise; indeed, that will be the motive for the change, but to the nation at large the value of the product is far less.

To a less extent the substitution of sheep farms for arable has similar effects, as in the enclosures in the fifteenth and sixteenth centuries.

Again, in making the comparison, it is not just to place on one side peasant properties, which are supposed to be free from mortgages (their greatest danger) and on the other tenancies with imperfect leases. The much-quoted aphorisms of Arthur Young are only half-truths: "The magic of property turns sands into gold." "Give a man the secure possession of a bleak rock, and he will turn it into a garden; give him a nine years' lease of a garden, and he will turn it into a desert." As will appear later on, equitable leases may be preferable to occupying ownership. Generally, it may be said that the effects of different systems of land tenure have been the subject of a vast amount of economic

research, and no simple or summary answer on their relative merits is possible.

2. Large and Small Farming Compared. — If we take farming in the common sense, of arable and stock mixed in varying proportions, we may conveniently compare the advantages under three headings — according to the three great agents of production.

As regards *land*, a large surface can be better split up into the necessary enclosure, it can be better provided with drains and roads, better adapted for the different kinds of produce required, and many of the operations can be more economically performed on relatively large fields.

As regards *capital*, the large farms usually have an advantage in buildings, implements, machinery, kinds of stock, insurance against risk, etc.

As regards *labour* on the large farms, there can be a better adjustment according to capacity, a greater command of scientific skill, etc. On the other hand, we have the greater interest in the work of the small holder who works for himself.

It was maintained by Mill that in farming not much division of labour was required, and that in the operations where combination of labour was needed coöperation might be adopted. For a time, both in France and the United Kingdom, this remained a counsel of perfection; but it is noteworthy that recently the coöperative principle has been applied with much success in agriculture, notably in Ireland and also in France.

The ardour of work, which used to be so much praised as the great virtue of the peasant proprietor, has of late years been painted in more sombre colours — the expe-

rience of France shows that the toil may be carried to the extent of the utter degradation of life. In the United States, however, three-fourths of the farms are cultivated by the owners; but as a rule they are of a class superior to the peasants of Europe, and do not suffer from the same drawbacks.

Comparisons are sometimes made of the average yield per acre of different countries with the implication that the highest yield has the best system. The question, however, does not admit of such an easy test, because the intensity of cultivation varies with the stage of development, the demand, etc. (cf. the law of diminishing return to land — Chap. VI below).

3. Historical and Social Influences. — As a matter of fact the actual distribution of the land of a country in large and small holdings depends on a variety of causes apart from the mere efficiency of the productive agents in the two schemes.

Among such influences to be considered are the conditions affecting the capital available for agriculture. Large farms involve as a rule large capitals, which may not be forthcoming, *e.g.* in new countries. In former times the want of large capitals was made good on the great manorial estates by forced labour and the forced loan of the oxen and ploughs of the serfs.

Conversely, economic conditions generally might be favourable to small farms, but there are not small capitals.

The rate of profit is often the determining factor. With high farming profits the large system is encouraged, while with falling profits the small system tends to take its place. Thus after the Black Death (1349–

1350) the rise in the cost of labour and materials dissipated the profits of farming by the lords of manors on a large scale. Through the land and stock lease (Rogers) and other modes of tenancy, the lands were let to small holders, many of whom eventually bought their holdings and became yeomen.

The small holder looks rather to a good return to his own labour and that of his family than to a profit in the strict sense on his capital.

In Scotland at present the conditions are favourable to the creation of small farms, but the difficulty is to find small tenants with sufficient capital.

Next to the influence of the conditions of capital we may notice the effects of the kind of produce for which the country or district may be adapted. Some of the products of the soil require minute care and supervision, others are naturally adapted to production on a large scale. Vines and wool may be taken as typical.

Closely connected with the kind of produce are the climatic conditions and the fertility of the soil. Thus in France itself, which is generally referred to as the country *par excellence* of the small system, nearly half of the total area is in farms of over one hundred acres, and only about a quarter of the total area is in holdings of twenty-five acres and under.

The demand, the proximity of towns, facilities of transport and marketing, are sometimes the most important factors to be considered.

The influence of the land laws is liable to be exaggerated, and seems to have more effect on the amount of the produce than on the size of the holdings.

Under modern conditions the relative rates of wages to be obtained in the towns and in the country have great influence. The small farmer, like the small shopkeeper, is a wage-earner, and does not subsist on his profit mainly.

From these considerations it is clear that we cannot argue from the success of one system in a certain time and place that it ought to succeed in times and places in which the essential conditions may be different — *e.g.* the Channel Islands and the Hebrides — Westmoreland in the eighteenth century and the twentieth, etc.[1]

[1] On the subject of this chapter there is a vast literature. For the general principles Passy's *Systémes de Culture* is still the best; Lady Verney's *Peasant Properties* may be used as a corrective to Mill, and to such works as Kay's *Free Trade in Land.* See also Marshall, *Principles*, Book VI, Chap. X; Nicholson, *Tenant's Gain not Landlord's Loss.*

CHAPTER VI

THE LAWS OF DIMINISHING AND INCREASING RETURN

1. Plan of the Argument. — As already explained, in any exposition of economic principles it is impossible to isolate entirely one department or even the particular problems in that department. But we may use hypotheses and presume the absence of disturbing causes, and we may alter the emphasis in dealing with the same subject-matter in the different connections in which it appears. So far in the present book the attention has been mainly directed to the nature of economic consumption and production, and to the modes of operation of the three great agents of production. We have now to consider the limits imposed on the productive capacities of a nation at any time by the limitations in the powers of these agents. In the concrete the question becomes: What are the limits to the increase of national wealth (or produce) imposed by land (or nature), labour, and capital, respectively?

2. The Law of Diminishing Return to Land. — It seems best to begin with the abstract or hypothetical method, introducing afterwards the various counteracting or disturbing causes. And even with the abstract method the law of diminishing return to land seems to require two statements; *first*, as applied to one portion of land, and *secondly*, as applied to the territory of a whole country, with great varieties in the qualities and advantages of

different portions of land. Mill said of this law that it is the most important in political economy, and with its deductions it has been perhaps the most subject to popular misunderstandings. The difficulties, however, will disappear to a great extent if we gradually advance from the simple to the more complex conditions under which the law may be supposed to operate.

As applied to a portion of land (say an acre) the law states that after a certain point is reached, other things remaining the same, the returns to successive applications or "doses" of labour and capital (or units of productive power) will continuously diminish.

The law is thus the exact counterpart of the law of diminishing utility, which was indeed so named on the analogy of this older law. Up to a certain point, as in the application of chemical manure, the return per unit may increase, but after a point is reached it will diminish and if the applications are persisted in, they may even become injurious.

Any change in the conditions affecting the environment of the piece of land or any change in the methods of production may alter the yield to successive "doses," just as in the same way the utility may change, although the thing considered itself remains the same.

It is plain, however, that, as stated, a similar law applies to any productive agent; *e.g.* coal and a steam engine, a factory and the number of workers, and so on. The peculiar importance in the case of land arises from the fact that land is limited, and the better qualities of land are still more limited; or otherwise, while capital and labour may increase indefinitely, land, as such, cannot so

increase, and any increase of the produce must be at an increasing cost, which is another way of saying that the return per unit diminishes.

This leads to the *second* form of the law in the case of land; namely, beyond a certain point every additional quality of land taken into cultivation gives a diminishing return per unit of productive power.

We may suppose that, to begin with, having regard to the state of the arts of agriculture, only the best quality of land is cultivated. In the shifting agriculture of primitive tribes they change their fields *per annos* and always *superest ager*, and whatever else these disputed words may mean, they describe a state of things to which this second form of the law does not apply. There is plenty of good land.

But in long-settled old countries that are self-supporting, after a certain density of population has been reached, the food supplies can only be increased either by the intensive application of capital to the land already in use, in which case the law in its first form comes into play, or resort must be had to inferior land, when the second or extensive form of the law operates.

As regards this second statement, it seems best to refer to different *qualities* of land, the quantities or areas being adjusted to the capital expended.

In the case of the produce being consumed at a distance from the place of origin, distance may be held to have the same effects as inferior quality. The cost of transport acts both on the materials and on the product. The principle may be applied that the act of production is not complete till the commodity is in the hands of the consumer.

In general the law will operate simultaneously in the intensive and the extensive forms; that is to say, the old settlements will be more highly farmed, and at the same time less fertile and more distant or less advantageously situated lands will be taken into cultivation.

The most economical application of the productive powers of the nation will be made when the marginal return in every case is just equal. (The analogy of the equality of marginal utility in the expenditure of a sum of money on different things may be noted.)

3. Counteracting Causes. — So long as the conditions laid down remain the same, the law in this combined form is like a law of nature in the physical sense (Mill). But the main interest of its application is in regard to the food supplies of any nation. Thus the question arises: As population increases, will the additional food always involve an increasing cost? And it is in the answer to this question that the counteracting causes are of such importance. As soon as we introduce the element of time, we have the probability in progressive nations of essential changes in the conditions. And the longer the period taken, the greater the chance of change.

Amongst the counteracting causes may be noticed: improvements in agricultural methods, *e.g.* rotation of crops, use of machinery, and scientific processes; improvements in the means of communication, which Adam Smith called the greatest of all agricultural improvements, — the introduction of new forms of produce, *e.g.* the potato and roots for feeding cattle. This topic might be indefinitely illustrated both from earlier and from modern times. Quite recently the cross fertilisation of grain

seems to have enormously increased the return to the capital expended.

It may be noted, also, that land which is inferior under certain conditions may become the best land under a different régime. Thus in new countries, even in modern times, the lands are first cultivated that are most accessible, and do not require much expenditure in clearing, just as for the same reasons the primitive tribes cultivated the hill-tops, which were near their rude forts and villages, and were also less covered with luxuriant vegetation. As Mill observes, there is scarcely any improvement in the arts of production generally which may not serve to counteract this law. Thus, improvements in machinery, and in transport, or in the manufacture of food products, or in the avoidance or the utilisation of waste — may add to the productive power of the society as regards its food supplies. Thus, the law does not state, that in the course of time, with the increase of population, the absolute marginal cost will increase, or that the last "dose" of labour (and capital) applied, will yield less and less as the years pass. Even when we take an isolated country, or one dependent on its own food supplies, this cannot be predicated. And still less when we take account of foreign supplies.

Thus the conclusion is reached that the law is only true under *statical* conditions, and that it cannot be formulated under *dynamical* or changing conditions, except under hypotheses which really reduce this case to the former. There are other theoretical difficulties that can only be indicated. Except in the simplest hypothetical cases, it will generally be necessary to meas-

ure both the applications of the doses of capital, and also the returns in terms of money. Otherwise it is not possible to take account of different modes of cultivating and of different kinds of produce.

But this again introduces the difficulty, that the price of the produce must always depend as much on demand as supply, and the influence of increasing population can only operate through demand. The growth of wealth may lead to food products being given to animals not themselves designed for meat.

4. Other Applications of the Law. — The law may be applied, *mutatis mutandis*, to fisheries, mines, and other products from land in the extended sense. A similar law may also be framed as regards building sites. Suppose that the main business of a town is carried on at the centre, or that for any reason the centre is preferable for residence. Then, as the margin of building extends, there will be diminishing convenience. At the same time, the buildings near the centre will be raised in height, and we may suppose the top story will cost more, and also that it will be less convenient.

Again, we may trace the growth of towns and cities, and discover counteracting causes similar to those in agriculture. Under different conditions, the attractiveness of the centre may be less, the means of transit to the outskirts, or again to the top stories, may be improved, and so on; so that we cannot say that with the increase of population, it will cost more and more to provide the marginal accommodation including under that term the access to employment. Some of these points will again come up for discussion under the theory of rent, and

also in the treatment of economic progress. In conclusion, it may be pointed out, that this law of diminishing return is deserving of close study, not only on account of its importance as applied to other parts of economic theory, *e.g.* rent, population, value, etc., but also as an example of method. In the abstract form, it is the best illustration of the working of marginal increments, whilst on the inductive and historical side, it gives rise to many fruitful lines of inquiry.

5. The Law of Increasing Return. — The law of increasing return in its formal statement is the exact analogue of the law of diminishing return: under certain conditions every additional unit of productive power gives a more than proportionate return.

As thus stated, the law may be observed under certain conditions even in agriculture. In fact, it is only after a certain point is reached that diminishing return sets in, and up to that point there may be increasing return. This is constantly observed in new countries. And there the law may be said to apply to the whole productive powers of the community; that is to say, in new and undeveloped countries every increase of capital and of labour may give a more than proportionate return. This is the theoretical justification of large borrowings for productive purposes and of bounties direct or indirect on immigration.

In a sense the law may be said to express in a summary form the advantages of division of labour and of production on a large scale which render possible the adoption of various internal and external economies (Marshall).

It is a matter of common observation that with many things an increasing quantity can be produced at a lessened cost per unit on the average, *e.g.* books, etc. Again, in most manufactures, up to a certain point, every increase of the scale of production seems in general to give increasing return. English writers under the influence of the industrial conditions that prevailed after the industrial revolution were inclined to suppose that in the course of progress diminishing return always came into play in agriculture and increasing return in manufactures.

But once we leave static conditions, no such tendency can be proved to prevail. It has already been shown that in the case of land diminishing return may be counteracted in a variety of ways, and as regards manufactures generally the most potent causes of improved production are to be found, not in the economies introduced by extending the scale of the business, but in all kinds of scientific discoveries. But from this point of view it is possible that over any long period there may be greater discoveries in the production of raw materials of all kinds, including food supplies, than in the corresponding manufactures.

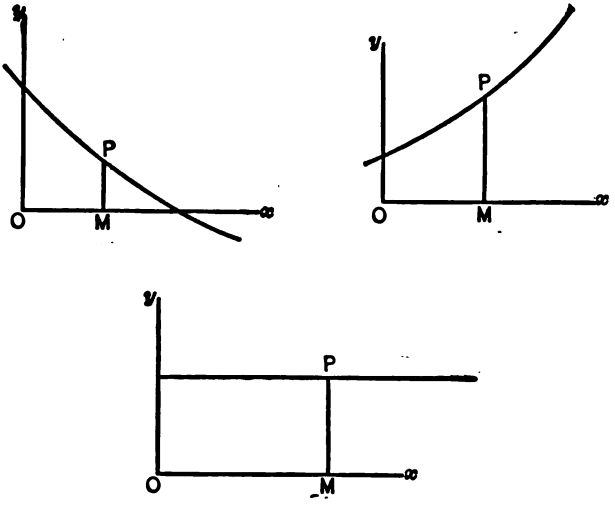
It may also be pointed out that as regards particular businesses there must be a limit to the advantage to be gained by an increase in size, or in each industry there would soon be only one firm left. A reference to facts of modern industry show that the same result may be achieved in very different ways. The law of increasing return does not state that every increase of the size of manufacturing concerns is associated with an increase of productive power.

Again, if we refer to the localisation of industries, no doubt the growth of towns and cities is often accompanied by an increase of facilities of transport and of various other economies of production in the extended sense; but it cannot be said that there is any necessary connection between the growth of cities and the growth of their manufacturing industries. It is quite possible that with the great improvements in transport we are on the eve of centrifugal distribution of industrial power.

These questions will call for further consideration in considering economic progress. (See below, Book IV.) One of the principal applications of these laws of increasing and diminishing return is in the theory of normal value, especially in dealing with the effect of an increase of demand for certain things. In this connection the law of *constant return* is also of importance; so far as production is concerned it may be said to indicate the balancing of diminishing and increasing return. As a rule in every case we have a conflict of opposing tendencies, and according to the result we have constant, diminishing, or increasing return. And as regards the same commodity at different times under different conditions, we find that it may be produced according to each of these laws in turn — that is to say, it is not the kind of commodity, but the conditions of production that determine which law operates.[1]

[1] See Marshall, *Principles*, Book IV, Chaps. III and XIII; Sidgwick, *Principles*, Book I, Chap. VI; Hadley, *Economics*, Chap. VI; Cannan, *Production and Distribution*.

ILLUSTRATIVE CURVES



Along *OX* measure units of productive power and along *OY* the corresponding products to the successive portions. Fig. 1 represents diminishing return; Fig. 2 increasing, and Fig. 3 constant return. For different purposes the units of power and the returns may be measured in different ways. Later, in the theory of rent, it is convenient to separate produce and money rents. In general it is simplest to consider money expended and the money return. In the figures as given no more is intended than an illustration of the variations in the returns. The mode of measurement is a matter of indifference.

CHAPTER VII

THE PRINCIPLE OF POPULATION

1. The Theory of Malthus. — The limits of this work do not admit of any history of the development of theories. If an exception were to be made, some account might well be given of the *Essay on the Principle of Population*, by Malthus, and its influence on subsequent thought. Here it must suffice simply to warn the student that his work has been much misunderstood, and that J. S. Mill is to blame for much of the misunderstanding. Mill's morbid dread of the increase of population was pushed to such an extreme that it vitiated his whole treatment of the wages question. It led him also to disfigure his work with irrelevant reflections on the immorality of large families, and generally on what may be called the immorality of imprudence; and for these extreme opinions there is no support in the *Essay* of Malthus or in the history of peoples, or it may be said in the common-sense of mankind. Indeed, Mill's morbid dread of the increase of population is one of the curiosities of economic literature, and is especially curious under present conditions. In France, of recent years, there seems to have been not only a falling off in the rate of increase, but actually a fall in population itself; and Leroy Beaulieu has maintained that the natural tendency of the democratic principle is to lead to a check

in the growth of population. Recent publications have also shown that the opinions of Mill, at the time, called forth an answer which showed that, even in savage communities, in spite of the abundance of the means of subsistence, the population might dwindle.

The connection of the work of Malthus with that of Darwin has also been misrepresented, and a critical study shows that the leading ideas of the Darwinian theory are not applicable to human beings, at any rate in historical times. The growth of population depends on a multitude of social and moral factors, as well as on physical conditions. One of these causes — or it would be better to say one group of causes — is found in the demand for labour, an aspect of the question to which much attention is being given at present (though it also was emphasised by Adam Smith). Another cause, it is true, is always found in the conditions affecting the food supplies or necessaries generally. It is to this latter cause that the work of Malthus was mainly directed, though indirectly, owing to the necessary connection of economic forces, other considerations are introduced.

2. The Three Propositions of Malthus. — The theory of Malthus as summarised by himself may be stated in three propositions and a qualification.

The first proposition states that population is necessarily limited by the means of subsistence. This proposition is obviously true, and the only point to notice is that the phrase *means of subsistence* must include more than food, *e.g.* fuel and the means of providing clothing and shelter; and as civilisation advances a still more extended meaning must be given. But taking food alone, it is plain

that the supply of food itself is one of the necessary limits to any possible increase of population.

The second proposition may be given in Malthus's own words, "Population invariably increases when the means of subsistence increase, unless prevented by powerful and obvious checks." This proposition is itself given with an important qualification, namely, that the increase in the means of subsistence must be such as the masses of the people can command; that is to say, the actual system of the distribution of wealth must be taken into account. It is plain that this second proposition, even with the qualification appended, needs an inductive proof. And such a proof is attempted by Malthus in an elaborate investigation.

This proposition has also been most liable to misunderstanding. The point is not that population must increase if subsistence increases, but only that it will so increase *unless* the tendency is counteracted by certain checks. As a matter of history, taking the population of any nation as a whole, there has very seldom been any pressure on the means of subsistence, though there has nearly always been a certain class of the society which, having regard to its command of purchasing power, has not sufficient food to rear the children that are born.

The question then arises, What are these checks? and the answer is given in the third proposition. "These checks and the checks which keep the population down to the level with the means of subsistence are moral restraint, vice, and misery." The ultimate check is the want of food, but this ultimate check is never the immediate check except in cases of actual famine. Famine is,

however, comparatively rare, and consequently the immediate checks must be sought for in other conditions.

These checks may be divided into two great classes, namely, those which tend to diminish the birth-rate and those which increase the death-rate; the former are styled preventive and the latter positive. The preventive checks are, speaking broadly, either of the nature of moral restraint or of vice. By Malthus, the expression *moral restraint* is used in a narrow sense as equivalent to abstinence from marriage not accompanied by irregular gratifications. The preventive checks that come under the head of vice are found to exist in the lowest stages of barbarism and in the highest stages of civilisation.

Of the positive checks some arise unavoidably from the laws of nature, *e.g.* the inclemency of the seasons or the exhaustion of natural resources. To these the name of misery is specially applied. Other positive checks, however, are wholly or partially the results of vice (in a large sense), such as wars and excesses of various kinds. For the illustration and the inductive proof of the operation of these checks, the student must refer to the essay itself. He will find incidentally many correctives to popular opinions. Thus the permission of infanticide, as in China, is said to be a cause of increase, not of diminution of population; for the permission removes the fear of the consequences of early marriages, but when the children are born, the natural instincts override the permission except in cases of extreme necessity. Again, slavery is unfavourable to an increase of numbers, while with great and continuous emigration population may increase.

To resume the main argument; the sum of all these

preventive and positive checks taken together forms the immediate check to population; and in every country some of them are in constant operation with more or less force. In general, also, there is a part of the population that tends to multiply to such an extent as to press on the means of subsistence — always, that is to say, having regard to its command of purchasing power. It is quite possible, however, that apart from this lowest class the increase of population may be less rapid than is advantageous to the community at large. Accordingly, in dealing with questions of population, it is necessary to consider the various classes as well as the aggregate.[1]

[1] See Bonar, *Malthus and his Work;* also *Philosophy and Political Economy*, Bk. III, Chap. I; Cannan, *Theories of Production and Distribution;* Nicholson, *Historical Progress and Ideal Socialism.*

CHAPTER VIII

THE GROWTH OF CAPITAL

1. Meaning of the Growth of Capital. — There is a popular idea that the greater part of the capital of a nation has been accumulated in the distant past, and that each year only produces the increase. The principal object of Mill's third proposition on capital was to call attention to the erroneous nature of this idea; he points out that all capital is consumed (meaning destroyed as such), and is being continually reproduced. In modern societies it may be said that it is only the value that remains constant, the things that possess the value being subject to change. From this point of view any difference in value constitutes profit (or loss); and if there is a surplus profit, it may be added to capital or immediately consumed as income.

The root idea of the various forms of capital is, as already explained, "prospectiveness"; in other words, the characteristic utility of capital is the satisfaction, directly or indirectly, of future needs and desires. The constituents of real income satisfy present needs. It follows that the simplest form of creating capital is putting aside directly a stock of consumable goods for future use, *e.g.* the corn buried by the ancient Germans in the ground, and similar primitive hoards. This is saving in the most elementary sense. Even in this case it may well

happen that the saving is made from a stock that is for the time being superfluous; but in general the provision of the surplus will involve a certain amount of labour or effort, or there may be a conflict between present and future needs. Thus, generally it may be said that the creation of capital involves in some way the sacrifice of present to future utility. This, however, is only true in the broad meaning of the terms, and it cannot be said that in modern industrial societies the sacrifice on the part of the great capitalist involves any personal abstinence from present consumption. As regards smaller incomes, however, this choice between the present and the future must often be made.

In modern societies, however, even in these cases, the saving is not of the character of hoarding. It depends rather on the direction that is given to industry by the demand, or on the distribution of purchasing power. The process is at the same time facilitated and concealed by the intervention of money. A person with a certain money income has so far a certain command of the national wealth. His money demand or expenditure will set in motion certain industrial forces. He may elect to buy things for direct immediate use of such a kind that they are destroyed without leaving anything of utility for the future. Or he may demand quasi-permanent forms of consumption-capital; or directly by purchase for his own business or indirectly by investment in the businesses of other people he may demand various forms of productive capital. The most effective criticism of Mill's fourth proposition on capital (that demand for commodities is not demand for labour), is afforded by regarding the real national income

as a flow or stream of commodities that is continuously resulting from the use of the national productive agents. According to the orders of consumers or of those possessing the money incomes, more or less of this stream is directed to the satisfaction of future wants, and thus to the future employment of labour.

2. The Limits to the Growth of Capital during any Period. — In modern industrial societies, in measuring the growth of capital it is necessary to use money. We cannot, like the ancient patriarchs, enumerate the details of our possessions, the oxen, the camels, the asses. It is only by using money as the measure that we can allow for substitutes, and the increasing variety of the forms of capital.

With this proviso it may be said that the maximum that can be added to the material capital of any society during any period, say a year, is the total net product, — that is to say the excess of the annual produce above what is needed to provide for the efficiency-necessaries of the workers, the supply of raw material, etc., the repair of the auxiliary capital, etc., and keeping up the consumption-capital (*e.g.* the dwelling-houses). The forms of capital, and also the net product must be, as explained above, measured in money. This real net product, measured in this way, obviously includes more than the profits on capital (in the widest sense of the term profits), as savings (in the economic sense) may be made from wages, especially if the term is used so as to cover the highest forms of labour, *e.g.* professional skill.

The amount of the net product will depend in the first place on the total annual dividend or real national

income. The larger the gross income, so much larger, other things remaining the same, is the net product.

The net product will be increased by anything that increases the efficiency of the productive agents or economises their use. Thus, in considering the possible increase of the net product, we are concerned with the limits of the *power* to save; in considering the causes that induce people to save rather than to consume their wealth immediately, we are concerned with the *will* to save. The actual saving affected during any period will depend on these two groups of causes.

3. The Power to Save. — In considering the causes that affect the power to save, and changes in that power, we must take account of all the factors of national production. Here it will suffice to enumerate simply the principal headings under which the inquiry must be made as regards the aggregate production and its cost — including, under the term *cost*, the various elements noticed above requisite to keep the forms of capital in *statu quo*.

Such are the natural resources and powers (see Chap. II); the efficiency of labour and capital (see Chaps. II–V); and the amounts taken by government for public purposes. In this last case the indirect expenses (*e.g.* restraints on trade), and burdens (*e.g.* conscription), as well as the taxes, must be taken account of; and *per contra* the nature of the expenditure of the public revenue must be considered. Other elements to notice are the extent of foreign trade, the means of transport and communication, and the credit system of the country. Whether credit itself should be included under capital is a question of definition, but there can be no doubt that credit increases the efficiency

of the productive agents in the same way as improvements in auxiliary capital, and it also effects economies that are equivalent to the saving of capital.

4. The Will to Save.—The will to save, in the economic sense of turning wealth to capital uses, depends on and varies with a number of factors.

One of the most far-reaching and varied in its modes of working is security. If there is to be any saving at all, there must be security that what is saved will be preserved to or enjoyed by the owner, at any rate to such an extent as to balance the sacrifice and effort required to create the capital. Even slaves, it has been found, will save out of their small *peculium* if sure of their savings. Security includes the security afforded by the state against violence or fraud or breach of contract on the part of individuals, and also protection against the arbitrary exactions of the government itself. Arbitrary and oppressive taxation is one of the greatest hindrances to the accumulation or investment of capital. Compare the provinces under Turkish misrule with Egypt under British administration. There must also be security against the violence and uncertainty of the powers of nature. If a country is liable to frequent earthquakes or other physical disasters, or has an unhealthy climate, life and property are uncertain and little store is set by the future.

What is spoken of as the effective desire of accumulation really consists of a group of motives. It may be weak from intellectual deficiency or lack of the telescopic faculty (Marshall), as in the case of the Indians mentioned by Mill, and indeed of primitive peoples generally; or there may be moral deficiencies, *e.g.* no strong

interest in others, no sufficient family affection, no desire to avoid dependence in old age. The hope of rising in the social scale and the importance attached to the mere possession of wealth as such, apart from its uses, have always been factors of importance, and were perhaps never stronger than at present.

The way in which the aggregate of the national wealth is distributed amongst the different classes of the community often makes considerable difference. Thus, as wealth was transferred from the landed aristocracy to the mercantile and industrial classes the growth of capital increased. Facilities for investment promote saving; the savings of the working classes have been greatly stimulated by the extension of savings-banks, building societies, etc., while the development of joint-stock enterprise has promoted saving generally. In the latest returns to Schedule D of the British Income Tax the gross assessments on the incomes of public companies exceeds the amount on the profits of private persons and firms.

The effect of the rate of interest depends on a balancing of opposing influences. If the rate is high, or rises, so far there is a greater reward for saving, and thus a direct encouragement to save. This high rate may, however, react on labour. For, other things remaining the same, if more goes by way of interest to capital, there is so much less for the wages of labour; thus, so far there is less stimulus to exertion, less efficiency, and on the whole a smaller fund or "flow" from which savings can be made. Thus a very high rate may check accumulation by lessening production. Adam Smith argued that the high rate of profit due to the monopoly of the colonial trade

had, on the whole, an adverse influence on accumulation partly because it increased the extravagance of merchants and checked "parsimony."

Again, a high rate may be a sign of insecurity generally.

Thus, on the whole, we cannot say that if the rate of interest rises there will be an increase in the rate of accumulation.

If the rate is low, or falls, people must save more for an annuity of a certain amount, and thus more is devoted to the forms of insurance. Labour also obtains a greater reward, and the industrial machine works so far at higher pressure. A low rate of interest also gives a stimulus to new undertakings that give promise of a better return. "John Bull can stand most things but he cannot stand two per cent."

A low rate of interest may be a sign of good security.

5. The Growth of the Different Species of Capital. — So far the question of the growth of capital has been treated as if the national capital were homogeneous in character and as if the various causes examined operated uniformly; it is necessary, however, to distinguish different cases.

As regards circulating capital, including raw materials, labourers' necessaries, etc., the better the industrial organisation so much the less need is there for an accumulation of stocks. The forms of capital are continuously replaced as they are required. In place of the storing up of a fund we have the direction or control of a stream or flow. The idea of public granaries is a case of reversion to a primitive type.

On the other hand, the forms of consumption-capital (in the sense defined), *e.g.* houses and their furnishings

of all kinds, tend to increase greatly, both in quantity and in value (as indicating quality). This is especially the case with a low rate of interest, because it becomes cheaper to build new, than to rent old, houses. In the course of industrial progress, the forms of fixed and auxiliary capital tend to increase greatly. The law of substitution (Marshall), that is to say the substitution of less expensive for more expensive agents or factors of production, is exemplified by the displacement of costly labour by machinery. The application of new scientific ideas to industry also generally involves the creation of new forms of capital.

Land and natural agents are not as a rule included under capital in the department of production, and strictly they are incapable as such of increase. But they may be indefinitely improved by the capital that is sunk in them. Adam Smith regarded agricultural improvements of a permanent character as the most advantageous of all the forms of national accumulation. But the amount of capital in this form depends largely on the competition of foreign supplies with home produce. Recently in the United Kingdom, in contrast with the great growth of capital, generally there has been a falling off in many districts in the amount of the capital sunk in the land. And capital in this form, like other forms of capital, needs constant renewal.

Similar reasonings may be applied, *mutatis mutandis*, to the various forms of immaterial capital, *e.g.* the development of banking and credit generally, and of systems of education. Some of these forms are more fully treated at a later stage (Book III).

6. The Limits to the Production of Wealth. — As illustrating the course of the argument of the last three chapters, attention may be directed to the statement by Mill, that the limited quantity of land and its limited productiveness form the real limits to the production of wealth. This position appears to be due partly to Mill's exaggerated idea of the operation of the law of diminishing return, and its consequences on population and the food supplies, and partly it seems to be a survival of the Physiocratic analysis of production, namely, that only labour devoted to the land could increase the aggregate of national wealth. But even if we take an isolated country, and suppose that for a long period the same amount of raw materials of all kinds are taken from the earth by the same methods, there may still be a continuous increase in the quantity of wealth. The labour may become indefinitely more efficient and skilful, and the raw materials may be worked up into more and more complex and artistic forms of wealth. In fact, as Malthus, himself pointed out, wealth may increase indefinitely long after agriculture has become stationary.

But notably in the modern world, and specially as regards the United Kingdom, any one country is not isolated as regards its food and raw materials. In any country, the production of manufactures can be increased indefinitely so long as the labour and capital are forthcoming; and the whole world is open for the provision of materials and food supplies. So long then as this country can find markets for its manufactures, the limitation of its land cannot check the growth of its wealth. It is sometimes argued that the food-supplying countries

themselves, increase in population, and will in time require all that they produce. But, as will appear more clearly under foreign trade, a nation must not be regarded as an individual; it consists of a number of classes with divergent interests; it is to the interest of the farmers to sell to the highest bidder, and a rich manufacturing nation would always furnish a richer set of customers than the poorest classes in the food-producing country. Of course theoretically there might be some danger of prohibition of the export of food, but this could hardly arise in all countries at once, and the blow to the agricultural interest would be so severe that the case is of little practical concern.[1]

[1] See Giffen, *Growth of Capital;* Marshall, *Principles*, Book IV, Chap. VII; Boehm-Bawerk, *Capital and Interest* (translated by Smart).

BOOK II

DISTRIBUTION

CHAPTER I

DISTRIBUTION AND PROPERTY

1. Meaning of Distribution. — In popular discourse, the term *distribution* often refers to the transference of commodities from place to place or from person to person; or, in other words, the term refers to the operations of wholesale and retail trade as contrasted with production in the narrow sense of manufacture, etc. But as already explained, logically distribution in this sense is part of production: there is a continuity of processes until the commodity is in the hands of the consumer. There is no doubt one aspect of trade that calls for special treatment, namely, the causes that determine the rates of exchange. This is the problem of the third great department of economics.

Distribution in the economic sense (here adopted) refers to the division of the wealth of a nation amongst the different classes. The leading conception is appropriation.

The first problem of distribution in this sense is to examine the meaning and the economic foundations of the institution of property, and the limitations that are imposed on the right of property under different conditions. It is found that the idea varies between two extremes: in the one the power of the individual is as large as possible; in the other, the power of the state, as expressed by the central or local authorities, is dominant.

Thus, on the one side, we have the various forms of private property; and on the other the various forms of property in common (*e.g.* village communities) that have existed or still exist, and the various forms of socialism that for the most part must be regarded as ideal.

The second great problem is to determine the economic laws that govern the quantitative distribution: first, of the agents or means of production, that is, the land, the capital, and the labour (when labour, as in slavery, is the subject of appropriation); in this connection it may be remarked that the economic characters and the effects of the laws of bequest and inheritance are of fundamental importance. And secondly, this part of distribution treats of the incomes derived from these agents; that is, the rents, profits, and wages. Here, in modern societies, exchange is in many respects fundamental, and the distribution of incomes may be said to depend on contracts made for the exchange of the services of the productive agents. But exchange has not always been predominant in this way; on the contrary, here also the movement of progressive societies has been from status to contract; incomes were formerly determined largely by law, and custom with the force of law, external to the individuals concerned, and independently of their particular bargains. Even under modern conditions the forces included under law and custom affect distribution to a considerable extent. Lately in Ireland and the Highlands of Scotland, there has been a reversion to the method of judicial rents, and in some of the colonies attempts have been made at judicial wages.

It is plain from this brief survey that the problems of

distribution in the sense defined cannot be brought logically under exchange. In the department of exchange, as a rule, nothing is said of the institution of property or the laws of bequest and inheritance; similarly, there is little scope for the discussion of the economic effects of laws affecting certain forms of property (*e.g.* the land laws), or of laws affecting certain contracts for wages, especially real wages.

At the same time it may be admitted that many of the problems of distribution, especially as regards incomes, depend on value. But, as already observed, all the economic departments are closely interconnected.

2. On the Nature of the Laws of Distribution. — It was shown at an earlier stage that the expression *economic laws* admits of very different interpretations as regards cogency. Mill tried to show that there was a sharp distinction between the laws of the production and those of the distribution of wealth. The former, he declared, partake of the character of physical laws — there is nothing optional or arbitrary about them; whilst the latter are of human institution only. I have examined this distinction (which Mill regarded as his most important contribution to political economy) in detail in the larger work; for the present purpose it may suffice to say that the distinction is one of degree only: the laws of production are not purely physical nor are the laws of distribution purely arbitrary; though, in certain cases in the latter, human wishes have greater influence than in the former. The reason why Mill attached so much importance to his discovery was that in it he found a theoretical justification for socialism, even in its most extreme forms. On this

view, "once the things are there" (as determined by the conditions of production), the state or society may do as it pleases with the distribution — or in Mill's phrase, none of these ideal schemes are truly impracticable, that is to say, not in the sense in which an indefinite increase from a limited portion of land is physically impossible. It may be replied that the practicability of socialistic schemes, with any real meaning of the term, cannot be decided in this abstract manner. In reality, Mill's argument relies on a legal or political conception that requires careful qualification in jurisprudence or political science, and in economics is of doubtful value in any sense. I refer to the conception of sovereignty.

3. The Conception of Sovereignty and its Application to Distribution. — The idea of sovereignty as expounded in analytical jurisprudence (*e.g.* by Austin, who had great influence on Mill) is that in every independent political society there is, so to speak, a centre of power which, relatively to the members of the society, is absolutely supreme. In the theory of jurisprudence this idea is sometimes useful, and it must be assumed, generally, that any positive law enacted by the supreme political power can be enforced. But as used by Mill it was associated with another idea which may be expressed in the form of the "indefinite pliability of public opinion." This was the great motive power on which the old radicals such as Godwin relied. Since, at any rate, in any democratic society, public opinion is the ultimate source of political power, we have only to get any scheme approved of and it may be put into operation; and if enforced by the sovereign power it must succeed (theoretically).

It may be objected to this line of argument that it is exactly opposed to the leading idea of the traditional economic doctrine that begins with Adam Smith and culminates in Mill himself (in the last chapter of his work). The fundamental assumption of *laissez faire* is that the economic power of government is extremely limited, especially for the achievement of beneficial objects. At this point it is impossible to do more than state the fundamental opposition between these ideas of the unlimited, and the extremely limited, powers of government.[1]

4. Economic Definition of Private Property. — In modern industrial societies the institution of private property is generally prevalent as contrasted with primitive societies, in which land in particular was held in common. The extent to which private property has prevailed at different stages of progress is a subject to which great attention has been devoted recently, and a certain reaction has set in against the extreme views that were current on the communistic character of all forms of primitive property.

It is a case in which it is absolutely necessary to apply the historical method. Nothing can be more fallacious than the attempts to construct the social arrangements of primitive societies by the simple plan of divesting human beings of their civilised surroundings and supposing that otherwise there would be no change in their thoughts or ideas; to suppose, for example, that primitive man actually did act just as civilised man might be supposed to act, if thrown by shipwreck on a desert island. In truth, as Sir Henry Maine (the great populariser of the historical

[1] The economic functions and powers of governments are examined at length in Book V of this work.

method in this country) observes, in general, it would be safer to suppose that in primitive times men would act in quite a different manner. Recent researches on comparative superstitions have shown in a striking way how widely different are the ancient and the modern ideas of what is natural in social arrangements. And in primitive times religion had great influence on economic ideas and practices. With this brief indication of the difficulties involved in tracing the actual development of private property, we may pass at once to the definition as applicable in modern industrial societies. And for this purpose the statement of Sidgwick (*Elements of Politics*, Chap. V) may be taken as the basis. "The right of property, when used without qualification, involves the complete right of exclusive and quasi-permanent use, the right to destroy, and the right to alienate (*i.e.* to dispose of to another by gift or sale) but not necessarily or logically the right of bequest." It may be remarked, as showing the difficulty of the subject even when we are dealing with abstract conceptions, that Mill is of opinion that the right of bequest is logically included. Leaving for the present the discussion of this point, we have next to consider what are the economic foundations of this right.

5. The Economic Bases of Private Property. — "The foundation of the whole institution," says Mill, "is the right of producers to what they have themselves produced."

This *first* basis may be called briefly the *labour* basis of property. It may be traced through Adam Smith to John Locke, and in a less definite form to older writers. It is often associated with the right to freedom of labour, *i.e.* the right to exercise one's powers and faculties in any

way that may seem good to the individual. Sometimes also it is associated with the right to labour, in the sense that the state ought in case of need to provide its members with work. Mill, who in this part of the subject avowedly introduces ethical reasonings, argues that this right to the results of one's own labour is a natural right of mankind; but, without entering into the difficulties involved in the conception of natural right, the expediency of this basis may be justified on purely economic grounds; namely, unless we allow freedom of labour and the right to enjoy the fruits of labour, the labour will not be forthcoming, or at any rate not to the same extent. Stated in this general form, the principle may be illustrated abundantly from economic history. As already pointed out in another connection, slave labour is of all forms of labour the least efficient, and as freedom is granted and the share in the proceeds is increased, the quantity produced also increases. The principle is also seen in modern times in profit-sharing, and it is well illustrated by the greater zeal displayed in piece-work in which the extra reward is directly associated with the extra effort.

A closer examination, however, shows that this basis, simple and obvious as it may appear at first sight, is beset with difficulties. In the first place, as soon as we introduce division of labour and a complex result due to the combination of many different forms of labour, there is the difficulty of separating the shares, *e.g.* in building a great ship, and, indeed, in any form of manufacture.

Again, in the economic justification given, it will be observed that the right (or the expediency of it) is stated with a qualification, namely, "to the same extent." In

the mathematical language that is now so much used in economics, the work done is a function of the reward. But, as shown in the very examples just cited, a moderate reward may suffice to call forth considerable energy on the part of labour, and thus a large amount of the produce may be left over for other claimants — the state itself or various privileged classes. In fact the economic justification is little more than the principle that is involved in the economy of high wages; and it would be absurd to say that the masters should in the pursuit of this economy surrender all their profits.

This illustration naturally leads to the statement of a *second* basis of property also admitted by Mill. People, it may be said, have a natural right to the results of their *capital*. On Mill's view the capital is itself the result of saving or sacrifice, and ought as such to be rewarded. But again, without introducing the ethical "ought," an economic justification may be given as in the corresponding case of labour. In fact, as already shown, a large part of capital in modern industrial societies is the result, not of saving or sacrifice in the narrow sense, but of that high form of labour called enterprise. It may also be said that, if a man has a right to the work of his head, he has a derivative right to any results from that work. But, apart from any right, the economic principle is that, unless capital receives at least a share in the product, it will not be forthcoming, or at any rate not to the same extent; and thus it is to the interest of even manual labour to pay something for the use of capital. The difficulty, however, again emerges as to the amount of the reward that is necessary or expedient.

The reference to the distribution of shares in a complex product for which many forms of labour and capital are combined leads up to a *third* basis of property which also is admitted by Mill, on moral grounds, namely, the *contract* basis. On this view, people have a right to the results of their contracts and bargains. Under this heading may also be brought the right to receive gifts from others — which at first sight would seem to cover the right to give and receive by bequest. (See the next chapter.)

This contract basis may also be justified on economic grounds. Freedom of contract is the very breath of industry in modern societies, as is forcibly illustrated by the fact that, according to the Constitution of the United States no infringement of this right is admitted. And it may be argued also that such a right is necessary to give a real meaning to the other two bases — that rest, namely, on labour and capital. On this view, freedom of labour means freedom to make a bargain for wages, which again means (when there is a product) a certain share in the product. And similarly of capital. The first and most natural meaning to give to these rights of labour and capital is that the shares of the various parties concerned should be adjusted by freedom of contract, especially in the form of freedom of competition.

And again, it may be pointed out that competition is the greatest stimulus to production, and that any check on competition lessens the aggregate produced.

This contract basis also at first sight seems natural and obvious, but it may easily be shown that there are great difficulties involved. In fact, it is to get rid of the abuses that are alleged to arise in connection with freedom of

contract and competition that all the efforts of socialism are directed. Socialists maintain that the terms of the endless series of industrial contracts in modern industry will only be equitably adjusted if all the parties are on an equal footing as regards opportunity, knowledge, and generally the power of making and understanding a bargain. And it is urged that capital as a whole has greater power than labour, and that some forms of labour have greater power than others; and besides, there are all the complications introduced by the existence through generations of inheritance and bequest.

There is still a fourth basis to consider, namely, the right founded on *prescription*, which may be defined for the present purpose as resting on undisturbed possession for a time. The period necessary to give such a prescriptive right varies in different cases and is different in different systems of law. This basis obviously depends rather on expediency than on moral right, and may be justified by such arguments as the necessity of a *finis litium* and of giving certainty to the interpretation of contracts. And again, it may be said that security is essential to the prosperity of industrial societies, and that the general reason for allowing a title by prescription is the necessity of avoiding the disturbance of security. At the same time it is equally clear that there is no prescriptive right in institutions. The mere antiquity of an institution does not even give a presumption that it ought not to be disturbed. In fact, with modern ideas of evolution, the presumption may be said to lean the other way; what was suited to the ancient or the mediæval man it may be thought will probably not be suited to

the modern with the great change in social conditions. And it would be absurd to suppose that no change in the institutions of a country is to be made simply because in the period of transition there must be some shock to security and some disappointment of even reasonable expectations. In making changes of this kind the principal question that arises is: have the interests adversely affected any claim to compensation? — a question which demands separate consideration at a later stage.[1]

[1] This chapter corresponds to Book II, Chaps. I and II of the *Principles*. As a general introduction see Maine, *Ancient Law;* and on special points Menger, *Right to the Whole Produce of Labour* (translated) with Foxwell's Introduction; Sidgwick's *Political Economy*, Book III, Chaps. VI and VII; and *Elements of Politics*, Chap. V; Wagner, *Volkswirthschaftslehre*, Part I, Chap. IV; De Laveleye, *Primitive Property*.

CHAPTER II

INHERITANCE AND BEQUEST

1. Economic to be distinguished from Legal and Ethical Ideas. — In treating of the laws of inheritance and bequest, it is necessary to separate, as far as possible, the economic, from the purely legal and moral aspects. The actual positive laws that prevail in countries of the same degree of civilisation, *e.g.* England, France, Scotland, present considerable differences, which can only be explained by an examination of the historical development of the systems of law in these countries. Again, these laws, such as they are, might be criticised from the moral standpoint, and various reforms might be suggested in order to promote moral ideals. It is beyond the range of economic inquiry to consider, except indirectly, these legal and moral questions.

The economic effects of inheritance and bequest are, however, always of great importance. The actual distribution of wealth at any time (especially of land) depends largely on the cumulative effects of these laws; they also indirectly have an influence on production, and they must be considered in dealing with the tax system of any country.

2. General View of Bequest and Inheritance. — It is obvious on simple inspection that bequest and inheritance are logically opposed. If absolute freedom of bequest is allowed, there can be no compulsory rules of inheritance,

and, conversely, so far as such rules prevail they must limit the right of bequest.

Some writers (*e.g.* Mill) consider that freedom of bequest is part of the right of property. The idea is that a person can do as he pleases with the results of his labour and capital and contracts, and that logically death makes no difference to this right. Other writers, however, maintain that freedom of gift *inter vivos* is on quite a different footing from freedom of bequest. It is admitted on both sides that the modern idea of property implies exclusive use and power of alienation; but those who approve of special limitations on bequest argue that as soon as a person dies his individual power ceases, and the state must decide what is to become of his property,—the state may respect his expressed or presumed wishes, or it may act on other principles of distribution. And it is the fact that, both in the past and the present, freedom of bequest has been and is more limited than gift *inter vivos*.

It seems clear that the right of inheritance as such cannot be deduced from the right of property economically considered; it does not follow from any of the fundamental bases, and there is no prescription of institutions.

In ancient law (Maine) the unit of society was the family, and the property was, so to speak, held by the head in trust for the other members; in the case of death another took his place. So long as this was the ruling idea inheritance altogether overrode bequest. But one of the characteristic features of economic progress has been the disintegration of the family, and freedom of the individual has displaced the bonds of blood relationship to a considerable extent.

The development of freedom of bequest is of interest in showing the influence of other social factors on economic distribution. The mediæval church, for example, taught that every person ought to leave a part, at least, of his wealth to the church, for the benefit of the poor and the good of his soul. In time, on account of this teaching, death without making a will and fulfilling this duty was looked on with the greatest horror, and it became sinful to put off too long making a will. One of the horrors of sudden death was intestacy, and the greatest calumny to the dead was to say that he died intestate. An old chronicler records of an enemy of his convent that he was found poisoned, — and the climax is striking — "dead, black, stinking, and intestate." The origin and results of the rules of inheritance and bequest under the feudal system are also indirectly of economic interest, and their influence survives to the present day.

In the present survey it must suffice to say that the right of inheritance cannot be supported merely on the ground of long-established custom. The custom was partly due to social ideas and conditions no longer prevalent, and the custom itself had long since begun to be modified in favour of bequest.

3. Inheritance. — The grounds on which inheritance (as distinct from bequest) is at present supported may now be briefly noted. First, it is said that, in case the right of bequest is not exercised, the state should endeavour to do as the deceased presumably would have done. Intestacy is regarded as a mere accident. It is true that the state cannot look into the supposed wishes in every particular case, it must act on general rules. The question then

arises, What ought to be the basis of these rules? The usual answer is that the state should found its rules on the prevalent customs of bequest. So far it is implied that inheritance is to be considered as supplementary to bequest. Thus, if, as a rule, when people are left to themselves, they leave their wealth equally amongst their children (Adam Smith speaks of this distribution as natural), then in case of intestacy the state should make a similar distribution. If, on the other hand, as regards property in general or some form, *e.g.* land, primogeniture is the custom of bequest, then it ought also to be the rule of this supplementary inheritance. Mill, however, argues in effect that the state should consider, not the prevalent custom, but what the owner ought to have done according to some ideal of moral duty. Logically, this argument seems only applicable to the limitation of bequest in general in favour of this ideal. And even in modern times limitations are imposed on bequest.

4. Bequest. — In considering the limitations on the freedom of bequest, it may be observed, first of all, that, even if the right of bequest is supposed to be part of the right of property, we may still appeal to more fundamental principles. The economic bases of property (with which alone we are now concerned) only justify the institution in so far as it is necessary or expedient as a stimulus to the exertions of labour and to the efforts and enterprises of capital. No doubt the institution of property may be and is justified on other grounds, — ethical, jural, and political, — but with these we are not concerned. From the economic standpoint (as here understood) the ground for allowing the right of bequest is that to a considerable

extent the wishes of the deceased must be carried out as regards the disposal of his wealth, or a check is placed on enterprise and accumulation. But, leaving this principle intact, there are several obvious limitations that are generally accepted. Thus, admitting for the present that property in land is expedient on economic grounds (see next chapter), still, the right to lay down the order of descent of property in land for an indefinite period — entails in the strict sense of the term — is certainly not necessary to stimulate the owner to keep up and improve the property, and on economic grounds, indeed, may be shown to be the reverse of beneficial. The tendency of all recent legislation has been to diminish the power of tying up land. Again, as regards endowments, *e.g.* for relief of the poor, education, or religion, it is generally admitted that after a certain time (that varies according to circumstances) the state may change the rules and regulations laid down. Thus it has often happened that endowments for the relief of the poor of a certain locality have, in the course of time, by attracting worthless people from other places, done more harm than good. Similarly, endowments for some particular forms of education, owing to changed conditions, may be actually injurious to the educational interests of a locality or a whole country. Obviously, also, any bequest that is against the public interests should be restrained, and sometimes these interests are mainly economic.

In most countries, however, bequest is chiefly limited in favour of the children — that is to say, certain rules of inheritance are compulsory. If these rules are practically such as would be followed if freedom of bequest

were allowed, the restraint might seem to be only formal. And in the majority of cases this would be so, but some exceptions may be noticed. Compulsory inheritance may weaken parental control and lead to idleness on the part of the children. The advantage of primogeniture, said Dr. Johnson, is that it makes only one fool in the family. Again, it may well happen that an unequal division would be more advantageous to the children as a whole — some might need more than others to enable them to carry on their business or profession. And, especially in the case of very large fortunes, the testator might with advantage bequeath more to public objects than the law of inheritance would admit. Any hardship of this kind could, however, generally be surmounted by the simple expedient of gift *inter vivos*, which, besides, in most cases, is preferable to death-bed charity (Gladstone).

This last consideration leads up to the position that it is useless to attempt to limit too severely the right of bequest in the supposed interests of the public. Mill's idea that no one should be allowed to obtain by bequest or inheritance more than a certain minimum (not very high even in the case of children) is plainly impracticable. It would be defeated either by open gifts during life or by secret trusts — a device that has often been resorted to in order to evade unpopular laws. Here again we have an illustration of the effectiveness of the limitations imposed on the theoretical sovereign power by the actual will of the subject.[1]

[1] Compare Mill, *Principles*, Book II, Chap. II, secs. 3 and 4; Sidgwick, *Politics*, Chap. VII; Maine, *Ancient Law*, Chap. VI; Pollock and Maitland, *History of English Law*, Vol. II, Book II, Chap. VI.

CHAPTER III

PROPERTY IN LAND — EXPROPRIATION — COMPENSATION

1. Property in Land. — The question has been much discussed whether private property in land ought to be allowed. On the matter of right, it is said, that, since land as such is not the result of labour or of saving, it is on a different footing from other forms of wealth. For the time being it may be necessary or expedient to give exclusive use, but this need not involve the other incidents and privileges of private property. Under primitive conditions there was a periodical or possibly an annual division, and in Russia and in India a large part of the land is held by village communities. Even in the most advanced societies, it is maintained that the state or local authorities might fulfil the functions of landlord and take the rents. But, although agricultural land in its original state is not the result of labour and capital, most of its valuable qualities are (Mill).

It is best to consider first agricultural land, reserving, in the meantime, the case of building land. It is probable that the land of England, as it exists at present, owes most of its valuable qualities to the cumulative effects of labour and capital, *e.g.* as expended on drainage, enclosures, roads, and good tillage. Thus, so far as these qualities are concerned, land (agricultural) is the result of labour — it is saved, it is even manufactured.

Logically, then, land may be said to consist of two parts, namely, natural qualities (incapable of improvement or change), and capital of an ordinary kind mixed up with them. Mill argues that so far as these primary qualities are concerned, there ought not to be private property, but there might be in the case of the secondary qualities due to labour and capital. Thus he says: "Property in land is only justifiable so long as the owner is the improver;" and "Whenever the proprietor ceases to be the improver political economy has nothing to say in defence of landed property as there established." And again, "In no sound theory should the landlord be merely a sinecurist quartered upon the land." No doubt Mill's views were influenced by the condition of Ireland when he wrote, and by its history; and no one at present would defend the system, the evils of which were so gross and palpable. It is, however, always dangerous to argue from a particular case, and the general question must be considered on its merits. And here it seems enough to state that on all forms of capital interest is received, and for the interest, as such, the owner does nothing; take for example, the interest on consols or railway debentures, or any shares from which the element of risk is eliminated, and in which the shareholder takes no part in the management. Why, then, should the owner of land incur particular censure because he ceases to be the improver?

There are certain advantages of the landlord and tenant system as it prevails in England. As a rule competition will insure that the best use is made of the land; a good farmer can extend his holdings by renting more land as

a trader may borrow more capital; the farmer's capital may be used on the land instead of being sunk in purchase; the landlord may undertake the permanent improvements which are hardly possible without ownership; and the landowner is satisfied with a small return in the way of interest on the value of the land as a whole, on account of the social and other amenities incident on property in land, and thus the farmer gets the improvements cheap.

No doubt, if the full advantages of this system are to be obtained, there must be security for the investment of the capital of the tenant, and there must be bona fide competition and not monopoly. In the case of very small holdings it is possible (as Mill forcibly argues) that special legislation may be desirable; but tenant farmers, farming for profit on a relatively large scale under equitable leases, are, as a rule, quite as competent as any land court to secure fair rents, leases of suitable length, and compensation for their improvements. If the state were to become the universal landlord, it would be compelled to resort to routine methods, or else to leave the powers at present exercised by the private owners in the hands of officials, with all the risks of caprice or jobbery.

It is, however, hardly seriously maintained that there would be any gain by the substitution of state for private *management* of land; as a rule, those who advocate what is called the nationalisation of land think the advantage is to be found in the financial gain that would accrue to the state. And this naturally leads to the consideration of the principles of expropriation and compensation in general.

2. **Expropriation.** — The right of expropriation on the

part of the state simply means that any government can directly or indirectly take away, limit, restrict, or destroy any proprietary rights of individuals. As, for example, it may abolish some forms of property formerly allowed, *e.g.* slaves; restrictions may be imposed that lessen the value, as in the case of the three F's in Ireland (fair rents, fixity of tenure, and free sale of tenant right); the state may make any changes in taxation, which changes directly and indirectly deprive people of their property; it may abolish debts under certain conditions, *e.g.* arrears of rents and more generally the debts of a bankrupt; and finally, the state may transfer any form of property from one set of persons to another, as in giving compulsory powers of purchase to a railway or to some local authority. Furthermore, it may be easily shown that in the course of progress frequent occasions are sure to arise when it will be necessary or expedient to exercise this right in one or other of its forms.

At first sight it might appear that the right of expropriation is part of the idea of sovereignty, and thus is subject to no limitations. As already explained, however, sovereignty in this sense is a purely abstract conception and has a very limited range in economics. As regards expropriation, governments have been and are limited in many ways, *e.g.* in the United States by the Constitution (as shown in the case of the proposed income tax); and, in particular, public opinion and moral ideas of what is just or fair render it necessary for the state to give compensation. This right to compensation is the most effective limit to the arbitrary action of the state and is of the greatest economic importance.

3. Compensation. — It is found, however, that when expropriation takes place (of any of the kinds indicated) the compensation given varies indefinitely. It may exceed the market value (as in the *pretium affectionis* approved of by Mill in the case of land); it may aim at being just the market value, as in goods purchased for the public service (though the old practice of preëmption on the part of the crown was only gradually annulled); sometimes much less than the market value is held to be sufficient, *e.g.* insanitary dwellings; and sometimes no compensation is given, as when arrears of rents are cancelled; and sometimes not only is there no compensation, but a further loss is involved as in changes of taxation.

The degree of compensation to be awarded cannot be decided on economic grounds only, but so far as such grounds are valid they seem to be reducible to two general principles. *First*, the state must avoid any shock to security; and *secondly*, it must be prepared to recognise expectations sanctioned by public opinion in the interpretation of contracts.

Neither of these principles is to be taken as implying an absolute command or imperative. In economies there are no imperatives. Bentham's dread of insecurity was as intense as Mill's of over-population, but even Bentham recognised and stated that sometimes security must give place to security — a shock to security in one part of the body economic may establish more firmly the security of the whole system. Endless examples could be given from economic history. One of the best instances is found in the gradual mitigation of penalties for debt and in the development of the law of bankruptcy. In the same way

the limitations imposed on proprietary rights in land and capital of various kinds, which have been found necessary in the course of progress to prevent or remedy certain abuses, have in reality strengthened the institution of private property. Private property itself, economically regarded, is only a means to an end, namely, the provision of economic utilities to the community as a whole.

Thus it is quite possible that the compensation given on the purely economic principle of security might be less than would be given according to prevalent custom or actual law, and the question arises whether the actual practice rests on some deeper moral principle, or if it persists merely through the unreasoning force of habit, in which latter case it must in time give way to economic considerations.

Similarly, as regards the reasonable expectations implied in certain contracts, no hard and fast rule can be laid down. The important object from the economic standpoint is that the reality and efficiency of freedom of contract should be preserved. And again, greater freedom on the whole may be obtained by restrictions in certain directions, and the reasonable expectations of the community may be set against the particular and interested expectations of individuals. In case of conflict the best means of reconciliation often consist in giving a long notice that certain practices will no longer be permitted. We constantly find that a change in public opinion foreshadows legislation which will restrict proprietary rights; and contracts entered into with the reasonable prospect of such reforms being made ought to provide for their own insurance.

The question of the recognition of the right of compensation would, as Mill says, in many cases turn on what in the circumstances was sufficient to constitute prescription, that is to say, not on strictly legal, but on moral grounds. It is clear that, as the circumstances change, so also does the moral prescriptive right or, what for the present purpose is the same thing, the reasonable economic expectation.

At the same time a change in public opinion in itself does not justify the immediate abolition of proprietary rights without compensation. Action of this kind might not only injure innocent third parties (for all monetary contracts are far-reaching), but it might affect adversely security and contract in the society as a whole, and thus the state would lose far more indirectly by refusing compensation than it would gain directly.

Similar reasoning may be applied to the proposals that involve arbitrary confiscation of property in the disguise of taxation.

The case of land will serve to illustrate in the concrete the general principles involved.

Suppose that the state were suddenly to destroy private property in land without compensation to the present owners. The land itself would remain; and also its productive power in agriculture and its amenities and advantages for building would be unimpaired. But when once it is remembered that contracts based on the private ownership of land affect every part of the industrial system (*e.g.* through banking and insurance companies), it is plain that the shock to security and to freedom of contract would involve losses to the community far in

excess of any gain to the state through the confiscation. And the loss on balance would be still greater if an attempt were made to separate what were called above the primary and the secondary qualities, and to restrict the confiscation to the former.

Nor would there be the slightest difference in the real effects if the confiscation took the form of taxation to the full extent of the rental. Taxation, as will appear later (see Book V),[1] must be imposed on certain principles, *e.g.* equality, certainty, etc., and as proved by history in cases of the first magnitude, excessive and arbitrary taxation may suffice to destroy the economic activities of a nation.[2]

[1] The taxation of the unearned increments of building land is examined in this book.

[2] See Sidgwick, *Politics*, Chap. XII; also *Political Economy*, Book III, Chap. IV, §§ 13, 14; Mill, *Principles*, Book II, Chap. II; Burke, *Reflections on the French Revolution.*

CHAPTER IV

SOCIALISM

1. Historical Variations in the Institution of Property. — People who have become accustomed to particular laws and institutions are apt to suppose that they are essential to the well-being, if not to the very existence, of society. Mill, as already observed, attempted to get rid of this idea by appealing to the conceptions of sovereignty and the indefinite pliability of public opinion. A more effective way is found in the substitution of the historical for the analytical method. The appeal to history shows that in the past societies have attained a high degree of civilisation under laws, customs, and institutions, affecting property and the distribution of wealth, very different from those that prevail at present in England. We find, for example, the various forms of village communities and of feudalism appearing all the world over, as if they were necessary stages in the development of nations. Each of these systems, no doubt, had its abuses, and each was inimical to certain kinds of progress; but in idea, apart from the abuses, there was much that was attractive in both systems, and, so far as the idea was realised, security and the essential elements of social order were attained. History also shows that, as these systems decayed, the parts that survived were often those that were most beneficial, not to the nation as a whole, but to the ruling class; thus in the

great enclosures in England in the fifteenth and sixteenth centuries the ill-defined customary rights of the villagers were sacrificed to the technical legal rights of the lords of the manors.

Again, the feudal privileges enjoyed by the so-called owners of land survived the obligations incident on feudal tenures, and to this day dealings in land are hampered by survivals of feudal law.

The results of the appeal to history are confirmed by the survey of existing conditions and recent changes. The elements of economic well-being may be secured under very different systems, and when a revolution of system is effected, it may benefit a class more than a people.

In England, and generally in the industrial nations of the West, the course of reform as regards property consisted mainly in the abolition of useless or harmful survivals which had been retained partly through the *vis inertiæ* of mere habit and partly through the active support, when threatened, of interested classes. At the same time there were always reformers who wished to go much further, and to introduce revolutionary changes in the laws affecting property and the distribution of wealth. Some of these reformers seemed to think that their object would be best achieved by adapting the old ideas to the new conditions. Thus some looked to modernised and purified communities as the ideal, others to a modernised feudalism in which the king, for example, would be the first industrial, and the captains of industry take the place of the feudal barons. The *phalansteries* of Fourier and the *chefs industriels* of St. Simon are the best-known types respectively of these ideas.

Besides these, however, all sorts of schemes were proposed which involved revolutionary changes in the existing systems of property and distribution. And at the present time new schemes are constantly being put forward with the immediate or ultimate object of effecting a social revolution. All these schemes may be embraced under the comprehensive name of Socialism, though each of them is apt to arrogate to itself alone the pleasing but exclusive attribute — "the true."

Whether we apply the analytical or the historical method, it may be admitted of all these schemes that they are theoretically possible; there is nothing immutable about the present laws of distribution; whether socialism in any of its forms would be desirable or practicable is a different thing.

2. Definition of Socialism. — In a recent work on socialism, it is said that "no definition of socialism, at once true and precise, has ever been given or ever will be given" (Flint). The opinion is supported in the concrete by the critique of many attempts at definition, and in the abstract by the argument that "socialism is essentially indefinite and indeterminate; it is a tendency or movement towards an extreme; it may be very great or very small; it may manifest itself in the most divers social and historical connections; it may assume and it has assumed a multitude of forms." Economists, however, are constantly beset with similar difficulties of definition; they are always dealing with tendencies, continuities, and debatable margins, and economic ideas assume an indefinite variety of forms in particular instances, *e.g.* capital, labour, etc.

The following definition seems to cover most of the forms of socialism, omits none of importance, and effectively contrasts socialism with the present system of individualism: "Socialism in the generic sense of the term, embraces all such schemes as are intended to further the claims of society for social purposes as against the present system of individualism; or to promote the interests of the whole as against those of particular classes and individuals; the object of all such schemes being directly or indirectly revolutionary as distinct from mere reforms of the present system." In brief, the essence of socialism is, positively to promote the good of the whole society; and negatively, to destroy the present system (individualism) which generates or permits the injurious privileges of classes and individuals. Accordingly, just as socialists are critics of individualists, so they in turn are critics of socialists as regards wages, capital, property, interest, etc. And in a sense, the whole of political economy, when treated from the standpoint of the present system, is a critique of socialism. In this wide meaning, socialism has a vast literature, and the first requisite is to give some kind of classification of the varied schemes.

3. Classification of Socialistic Schemes. — In classifying the different schemes, we may take as the guiding principle the amount and degree of state interference that would be required as compared with the present system. With this leading idea we have: —

(1) Schemes that would involve *less* state control than at present. Of this kind were the schemes that sprang from the ideal of liberty of the French Revolution. It was supposed that social evils were, for the most part,

the results of the interferences of governments with the course of nature. Hence, in the extreme form, these schemes seek to destroy governments and restore natural conditions. Modern instances of this idea are found in anarchism and nihilism. It is not necessary, however, that, in order to promote this idea, resort should be made to violence; in England, for example, Godwin relied entirely on education and the power of opinion, though he hoped for the perfectibility of man with a minimum of legislative control.

(2) Next, there are the schemes that propose to establish *within the existing state* a number of separate socialistic bodies or communities. These would only require sufferance from the existing authorities. A number of experiments of this kind were made in America (*e.g.* Brook Farm). The names of Fourier and Robert Owen are best known in connection with this idea of socialism.

Schemes of profit-sharing, coöperation, and industrial partnership do not come under the definition, as they are essentially only modifications of the present system. Strictly speaking, these socialistic communities within the state might also be excluded on the ground that they do not promote the good of the whole society, but only that of their members. But in intention, at any rate, they are designed to leaven the whole lump.

(3) There are the schemes that involve a *greater* degree of state control both in legislation and in administration. In the extreme form we have collectivism or state socialism. The writer most referred to in this connection is Karl Marx, though he has derived many of his leading ideas from the early English socialists (Foxwell's Intro-

duction to Menger). Some collectivists approve of effecting the revolution by force; others seek within the limits of the present law to permeate society with socialistic ideas and gradually to socialise our institutions. To begin with, no doubt, writers of this school are only advanced reformers, but they are properly classed as socialists because their ultimate object is a social revolution.

It is sometimes said that the poor laws, factory acts, free education, etc., are socialistic in tendency, and the old phrase has been revived: "We are all, then, socialists." But such a large use of the term would take away all definiteness from the meaning, as the writers who are recognised as the strongest supporters of individualism may also approve of the legislation just cited. All economists, from Adam Smith, have admitted that abuses might arise under the present system which would call for governmental intervention, and also that certain industrial functions ought to be performed by the state. (See below, Book V.)

4. State Socialism or Collectivism. — The form of socialism that at present is most in favour is state socialism or collectivism, and a more detailed account may be attempted of the features, or rather tendencies, of this system. It is, however, difficult to form an adequate notion even of the tendencies involved, on account of the very different proposals that have been described under the expression *state socialism*. For the present purpose it seems best to take the system in an extreme or ideal form, so as to bring out the leading ideas in sharp contrast to the present system. From this standpoint the ideal aimed at may be described as the substitution of collective for private

ownership and management of the means of production (land and capital), and the displacement of competition by organisation under state control.

Under the present system, indeed, capital is often collected in large masses, and there is also, to a great extent, organisation of labour. But aggregation and organisation of this kind are the effects of the voluntary actions of individuals, — voluntary, that is to say, in the sense that they are not due to the initiative or direction of the state.

If, now, we seek to carry to its logical conclusions the proposal that the state should control and organise production, the first result is that there would be involved a similar control of distribution. If the state assigns the tasks, the state also must assign the corresponding rewards. Accordingly, obedience to authority must take the place of freedom of contract. The next logical result would seem to be that the state (through its official statisticians) must estimate the needs or the deserts of consumers. That is to say, instead of demand being estimated by retail and wholesale traders it must be estimated by authority in some form. This again would naturally lead to the abolition of trade and exchange. And, finally, with the abolition of exchange, the mechanism of exchange would no longer be required, and thus money, also, would disappear.

Extravagant as this conclusion may seem to be, it is only the logical sequence of the fundamental idea of collectivism. And it is worthy of attention on two grounds. In the *first* place, the supporters of the present system maintain that it is the result of a long process of evolution in which the substitution of a money economy for a

natural economy has played the most important part. The extension of the use of money is, in this view, the economic form of progress from status to contract. Of course under the use of money must be included the use of what is called representative money, or generally the development of banking and credit.

Secondly, it may be observed that many socialists (notably Marx) ascribe a large part of the abuses of the present system to the use of money; it is money that conceals the exploitation of labour by capital. And actually in the nineteenth century several crude attempts were made to substitute for money some kind of labour exchanges. Thus at any rate it may be said that the individualist emphasises the advantages of a money economy; the socialist, its disadvantages and abuses.

Some of the abuses and unjust inequalities of the present system are ascribed to the cumulative effects of the institutions of inheritance and bequest, which perpetuate the injustice of the past. And accordingly the abolition or serious modification of the laws of succession is generally part of the extreme socialist programme. But altogether apart from this historical source of injustice it is maintained that the system of capitalistic production under present conditions is productive of a continuous exploitation or robbery of labour. A redistribution of wealth would effect no radical or permanent cure of the social disorder — it is the system that is at fault. It was supposed that this conclusion (the continuous robbery of labour by capital) was the logical deduction from the analysis, by Ricardo and the so-called orthodox economists, of the system of production under the control of private

capitals. The natural tendency of wages (owing partly to the imprudent increase of population and partly to the greater bargaining power of capital) was to fall to a bare subsistence minimum — the celebrated iron (*eherne*, lit. brazen) law of wages; whilst surplus profits necessarily tended to increase indefinitely, and in particular the rents of lands tended to rise through the very causes that depressed the wages of labour. It was further supposed that in the course of the natural development of this capitalistic system the larger capitals would in time swallow up the smaller. Ultimately, then, the result of this evolution would be the division of society into two classes, a very small class of very rich and an enormous class of very poor — the millionaires on one side and the proletariat on the other. The evolutionary socialists, as they call themselves (though, curiously enough, Herbert Spencer is an extreme individualist), think that when this stage has been reached or is in sight the state must intervene and take over the large capitals, and that, owing to their magnitude and methods, the task will be easy.

Such, then, being the origins, the leading ideas, and logical consequences of state socialism in its extreme form, they may now be examined from different points of view. And, first, is this indictment of the present system justified?

5. The Socialist Critique of Individualism. — In the first place, it must be pointed out that every economist admits that in the present system there are very great social evils, *e.g.* pauperism, overcrowding, insanitary dwellings, and generally amongst the poorest such con-

ditions of livelihood and living as are destructive of all that is good in human life. And at the other end of the social scale (as measured by the possession of wealth) there are the evils connected with monopolies, the promotion of unsound companies, speculation, gigantic frauds, commercial crises, etc., and also all the evils that arise from misdirected or extravagant or immoral expenditure on the part of the very rich. These abuses are admitted by all observers. The conflict of opinion arises, first, on the extent and the degree of the evils, and secondly, on the causes. And it may be said at once that the questions involved can only be fully answered by inquiries that imply a reference to every part of economic science. In this place it must suffice to bring forward a few salient points for consideration.

The "iron" law of wages is not now accepted by any economist, even as a first approximation to the theory of wages. The larger part of gross profits is not mere interest obtained through the otiose ownership of capital, but is the result of enterprise and ability which, by the economies and improvements introduced, benefit society to a still greater extent, *e.g.* the profits obtained from the development of the means of transport and communication in the last century were small relatively to the advantages obtained by the nation or the world. Pauperism has many causes, and it is doubtful if the system of large capitals can be considered in itself as one of them (small holdings of land and the so-called domestic manufactures, as experience shows, may be at least associated with pauperism). There are counteracting causes to the amalgamation of capital (as already explained). The professional

classes, whose only capital is their skill, in many cases obtain higher "wages" than the employers of labour; manual labour is only one form of labour, and between the lowest and the highest forms of labour (in the extended economic sense) there are endless gradations. Production on a large scale can only exist with large markets, which implies large demand, which again means a multitude of consumers — this applies to every kind of production in the widest sense of the term; railways and ships can only grow by an increase of traffic, and as regards passengers it is the masses that pay best. There has been during the nineteenth century in the great industrial countries a rise in money wages and a still greater rise in real wages, and a fall in interest as such; and on the whole the condition of the masses of the people, in whatever way tested, has immensely improved. Thus it appears that the socialist critique of the present system, in the extreme form which regards the rich as the parasites of the poor and large (private) capitals as the root of all evil, is not supported by the first siftings of economic inquiry.

It remains to notice briefly the difficulties of the remedy proposed, namely, the collective ownership of capital.

6. Difficulties of Socialism. — Certain difficulties that are common to all forms of socialism may be noticed very briefly, as they are part of the common thought of the day. As regards the demand for commodities (in the broad sense) there would be a difficulty in the distribution of the things that are limited in quantity and of varying degrees of quality, *e.g.* the best sites for houses, the most pleasing parts of the country for occupations, etc. In

general, however, the difficulties of consumption might be met partly through the extension of the public means of enjoyment, *e.g.* gardens, theatres, etc., and partly by official estimates of the natural demand for various things, and the adoption of some scale of relative utilities that would command general acceptance; in the ancient village communities the appeal to chance (*e.g.* lots) was often resorted to, and in all times the judgments of chance have been popular. There was also the method of periodical division. An official average estimate might easily be made of the things that can be produced in practically unlimited quantities, freedom of choice in the ratios of the public utility scale being left to individuals. The real difficulty of consumption arises in connection with distribution. (See below.)

Given the estimated demand, or what the state in its wisdom considers a fair allowance of all sorts of things, the next question is: how are these things to be produced? Here the difficulties are more serious. Such are: as regards the choice of employment or occupation, and the apportionment of work, the alternatives would be authority with quasi-military power or a system of extra rewards in proportion to the hardship etc., of the work, or it may be the ability of the worker. In any case it would be difficult to give equal opportunities to each, and to exact equal quantities of labour. Other difficulties in connection with production are found in the motives that will induce the people to work in the new order of things. Self-interest would not operate to the same extent; but on the other hand it might be expected that there would be an increase of public spirit and *esprit de corps* (Mill).

The conditions of labour would also be much improved, and the idea that labour was something to be shirked would, it might be hoped, disappear. On this point it may be noted that, under the present system, the self-interest of the workers is only remotely aroused in the case of time wages, and also that a good workman all the world over takes a pride in good work. The disutility of work in itself has been ridiculously exaggerated. Given reasonable hours, healthy conditions, and above all contentment with the reward, and in most cases the work itself ought to rank as a pleasure.

The word *contentment* naturally leads to the difficulties of distribution.

On what principles are the various forms of wealth — material and immaterial — to be distributed? Apart from the forms of public or social wealth open to all, how much of general purchasing or controlling power is to be given to each? If money is retained in the socialist state, how are the rates of money wages to be determined when competition is excluded? As Mill observes, absolute equality (communism in his sense) might be accepted, so might chance (the spirit of gambling is universal), but not authority. The really weak point of most socialist schemes is in the excessive wisdom they require on the part of the necessary officials, and the excessive appreciation of the wisdom of the controlling powers on the part of those controlled. To all these familiar objections (and others might be added, *e.g.* the dangers of overpopulation, the difficulties of foreign trade, etc.) it is replied that the socialist state would only be gradually evolved, and that in the meantime, the

object ought to be to socialise our institutions. Apparently it is thought that the process might be stayed as soon as signs of failure appear. The difficulty of dealing with socialism in this form is that in the earlier stages there is nothing to distinguish it from reform of the present system. The only real distinction seems to be that the socialists would approve of the extension of governmental functions (central or municipal) partly on account of the educative effect on public opinion, or with the very idea of inducing people to rely on the state, instead of relying on themselves. The opposition of ideas is thus marked even when the same immediate object is approved, both by the individualist and the socialist.

The conflict between the two ideals from this point of view involves a consideration of the advantages and the limitations of governmental action in general — a topic that is so large as to require separate treatment (see below, Book V). Here it may suffice to say that in dealing with any case for governmental action (under present conditions) we have to answer two questions. First, Is the evil or defect complained of incapable of remedy by the free action of individuals? Is there a *prima facie* case for the interference, or at least for the deliberation, of government? And secondly, Can the government provide a remedy? Economic history is full of examples in which the remedy attempted by the state has only aggravated the disease, although at the same time there are examples, also on the largest scale, which show that the intervention of the state was too long deferred, and in the end was most beneficial (*e.g.* the factory legislation).

7. The Benefits of Socialist Ideals. — It is only fair, in conclusion, to notice briefly some of the benefits that may be fairly ascribed to the writings and the practical efforts of socialists. And first, as regards the development of economic theory, they may claim to have contributed greatly to the analysis of capital and labour. In some directions they pushed their conclusions too far, but they did much to restore to its proper place the human element in the production and the distribution of wealth. They realised that in production, against the cheapness of the product we must set the real cost in labour. It is impossible to exaggerate the horrible degradation of labour, in many industries on a large scale, after the industrial revolution. There is a foolish idea that examples that are notorious lose efficacy in proportion to the familiarity. The lessons of the horrors of child labour in the early part of the nineteenth century ought never to be forgotten or be dulled by familiarity. The socialists through their ideas promoted the legislation that remedied this and other evil conditions of labour. There were no doubt other influences (religious and moral), but the socialist analysis played an important part. Secondly, the socialists may claim a share in restoring to its proper place, in the national economy, the industrial functions of the state. Adam Smith, himself, it is true, had assigned to governments tasks enough to occupy all their energies; but his attacks on the abuses of state management had been so strong and so successful, that a species of *laissez faire* had become popular, which, if carried to its logical conclusion, would have reduced society to a state of nature (in the modern and historical sense of a state of

savagedom). The socialists did much to get rid of the excesses of *laissez faire*, both in theory and in practice. Finally, the socialists emphasised the importance of public spirit and of solidarity, which had been underestimated in the stress laid on the benefits of individual freedom.[1]

[1] The corresponding chapter in the *Principles*, Book II, Chap. XV, is written from a different standpoint. The literature of socialism and the allied topics is so vast, that a short selection of works is difficult. Kirkup, *History of Socialism;* Graham, *Socialism New and Old;* Rae, *Contemporary Socialism;* Gonner, *The Socialist State;* Ely, *French and German Socialism;* Karl Marx, *Capital;* Seligman, *Economic Interpretation of History;* Schäffle, *Quintessence of Socialism;* Holyoake, *History of Coöperation* (Vol. I); Flint, *Socialism;* Nicholson, *Historical Progress and Ideal Socialism;* Menger, *Right to the Whole Produce of Labour* (especially Foxwell's Introduction on the Early English Socialists); and the publications of the Fabian Society; Macrosty's *Trusts and the State*, and Webb's *Industrial Democracy* have an indirect bearing on socialism.

CHAPTER V

QUANTITATIVE DISTRIBUTION

1. Of the Quantitative Distribution of Property. — In the preceding chapters of this book we have been occupied mainly with qualitative distinctions. We have compared the general characteristics of production and distribution; we have considered the economic bases of private property; we have examined the nature of the laws of inheritance and bequest, or the modes in which property is allowed to pass from the dead to the living; and by way of interlude we have looked at the features of some of the ideals which have been set up in the hope of revolutionising these proprietary ideas and institutions.

Resuming now the main argument, the next problem or set of problems is to determine the causes that affect the quantitative distribution: first, of the agents of production themselves, and secondly, of the produce of those agents.

In both cases when we make a general survey we may distinguish between two sets of causes: first, those that are embraced under law and custom in the widest sense of the terms, and secondly, those that come under freedom of contract and competition, these terms also being taken in a large sense.

2. The Distribution of the Agents of Production as determined by Law and Custom. — The actual distribution of land, even at the present time, in old countries depends largely on law and custom. According to a recent calculation two-thirds of the whole of England and Wales are owned by 10,207 persons, two-thirds of Ireland by 1942 persons, and two-thirds of Scotland by 330 persons. Twelve owners have a quarter of Scotland, and nine-tenths of the whole of Scotland belongs to fewer than 1700 people.

In France, on the other hand, 50,000 proprietors possess each an average of 750 acres, 500,000 an average of 75 acres; and 5,000,000 an average of 7½ acres. There are in France 1,000,000 self-sufficing freeholds supporting 1,000,000 families without the need of earning wages. In Great Britain, so late as the nineteenth century, the large estates swallowed up a large number of the small properties of "statesmen" and yeomen. There can be little doubt that this great difference in the distribution of property in land is to be ascribed principally to differences in the laws and customs that have prevailed and still prevail in the two countries. In England, strictly speaking, the customs have had greater influence than the laws; in other words, the laws that have prevented the splitting up of the large estates in Britain are in the main permissive; the practice of family settlements has probably had most influence. In France, on the other hand, the rule of compulsory and equal inheritance has had considerable effect.

The actual quantitative distribution of capital depends

to a much less extent than land on law and custom. Their influence, however, is still great even in those countries in which freedom of contract is developed to the greatest degree, *e.g.* inequalities of fortunes are at any rate continued by the laws and customs affecting successions. But, in origin, the accumulation of capital in the hands of individuals is for the most part the effect of a series of contracts. It is doubtful if the direct operation of law could even restrict this concentration of capital so long as the principle of freedom of contract is left as the basis of the industrial system. More and more, with the progress of society, capital is distributed by monetary influences. And money is essentially mobile. The growth of the money power is best seen in the case of capital. As the history of the usury laws shows, the money economy, even in its most rudimentary forms, eluded the edicts of law and the dictates of religion; and with the development of banking and credit the freedom of money has increased. In economic analysis it is, no doubt, still important for many purposes to distinguish between the actual forms of material capital, and their money measures; but as regards both revenue-capital and production-capital, it may be said that the money value is essential to their existence. Machinery that loses its money value can no longer be ranked as fixed capital; similarly, if the revenue, reckoned in money, from any source ceases, the source is no longer capital. Even the quasi-permanent forms of consumption-capital (in the sense defined) are generally allowed to decay if their comparative money value dwindles.

In the case of labour, that is to say as regards owner-

ship, the direct influence of law is least of all under present conditions in the great industrial countries. Slavery in all forms has been abolished. Man, from being the chief form of property (Aristotle), has ceased to be property. Thus the laws of succession have here no place. So long as slavery existed, the distribution of slaves was of the utmost importance, and the various degrees of serfdom were only modifications of slavery. The abolition of proprietary rights in man is the most important strand in economic history. The owners of land and capital have, no doubt, still in many cases great powers over labour, analogous in some respects to the former powers of the owners of slaves and serfs, but they are better considered under the quantitative distribution of incomes (especially real wages, and on analogy, real rents).

3. The Quantitative Distribution of Incomes. — The great flow or stream of wealth, or produce (Sidgwick), or economic utilities (as here defined) finds its way ultimately through minute capillaries to the millions of individual consumers. But, to begin with, we may say that it is distributed in three main channels. Or, without further metaphor, there are three great species of income that correspond to the three great agents of production. The owners of land, capital, and labour obtain rents, profits, and wages respectively. Taking a broad view, and with simple or hypothetical illustrations, these incomes seem quite distinct. But economic analysis soon reveals that in reality they overlap or are blended in varying proportions. Economic rent, the share of the natural qualities of the land, is, in practice, inextricably blended with

profit rent, the share of the acquired qualities of the land; the largest part of gross profits is a form of wages. Even in the eighteenth century Adam Smith reduced a part of wages to profits of capital sunk in the production of the finished labourer; while at the end of the nineteenth Professor Marshall has reduced a part of the earnings of labour and capital to quasi-rents. It follows that all these kinds of income will require careful analysis to discover their real meaning and the real nature of their claims to rank as distinct species. The quantitative distribution of these incomes, or the discovery of the laws (economic) that govern the amounts of rents, profits, and wages, is a matter of still greater difficulty. It is to this group of problems that the attention of economists has recently been most directed.

It will be found that in each case law and custom still exercise considerable influence, but in the course of progress their influence has been more and more subordinated to that of contract. For a long period in England rents were paid in labour and produce, and real wages were paid in rights of occupancy of land, while the relations of the lord of the manor to his serfs were determined by custom with the power of law. And during this period most of the labour of the country was more or less bound to the soil. Even in trades, until the repeal of the Statute of Apprenticeship (finally in 1814), the justices of the peace were supposed to fix the rates of wages, though the law had long before fallen into disuse. At present, it is true, in many industries the distribution of earnings between wages and profits is determined by what is called collective bargaining, and though the direct

influence of law is small, that of custom is large. The direct effect of law is best seen in real wages, in which we take account of the conditions of work, etc.

The influence of custom is also still greatly felt in the department of consumption. It is astounding how little regard is paid to real utility, and how ill the means are adapted to the attainment of what is supposed to be the end of all consumption. But it is consumption that governs demand, and demand guides production, and production is intertwined with exchange and distribution.

To resume, a full inquiry into the quantitative distribution of incomes ought to explain : —

(1) How the three great species of incomes arise, and what are the causes that determine the relative amounts of each. Take, for example, the national income of the United Kingdom as measured in terms of money. Given the necessary statistics, it could be divided into three parts that are assigned respectively to the owners of land, capital, and labour. It is found also that the proportions assigned vary. What, then, are the causes and conditions that determine the relative amounts of these three great incomes at any time, and the changes from time to time? We are here concerned with general wages, general profits, and (by analogy) general rents.

(2) It should explain also the reasons of the differences in the subspecies of these great incomes, the causes of variations in the return to different kinds of labour, capital, and land. Here we are still dealing with comparatively large classes and aggregates. Taking labour in the extended economic sense, we pass by insensible steps from the simplest form of spade work to the

most complex form of brain work; the continuity is illustrated by the fact that the efficiency of the navvy varies with his skill, and the greatest engineer must learn with his hands (Nasmyth).

Similarly, profits may vary from the no-profit margin (Walker) up to the enormous profits of successful trusts.

In rents, the continuity in the gradations and the differences in the extremes are still more striking. Land (also taken in the extended economic sense) is used for very different purposes, and the aggregate rental of land will be distributed in different ways under different conditions. Even when we take economic rent in the strict sense as arising solely from natural qualities, there are different kinds with different origins.

(3) To some extent an explanation must be given why incomes vary from individual to individual in the same class. In all the highest forms of labour, *e.g.* in the professions, there are great differences between individuals, and it is most important to distinguish between the aggregate remuneration of the class and individual gains and losses (taking account of the expense of training, etc.). Similarly, there are immense differences in the profits of individuals, and the reasons of these divergences from the average must be examined.

4. Money Incomes and Real Incomes. — The real income of a nation consists of economic utilities, including consumable commodities and services that perish in the act. The largest class of labour is that of domestic servants of all kinds, and their services ought to be reckoned as equal in value to the amount of their wages, including the value of their food, lodging, etc. By analogy, also,

we ought to include in the real national income similar services for which no money is paid, and which are not estimated in terms of money; such are the services performed by the members of a family for one another.

In considering the share in the real national income that is consumed by any class or individual, this is often far less than is indicated by the money income. Any one who invests part of his income in any form in reality transfers to that extent his consuming power to other people. The millionaire himself may not consume for his own personal wants a hundredth part of his income; in his case a large part of his real income must be considered to be in the form of accumulated rights of property. And in estimating the value of this property the same things must not be reckoned twice over. Thus we ought not to include both the income of the railways and also the aggregate of the incomes of the shareholders. In dealing with wages in the narrow sense of the term it is usual to assume, in distinguishing between real and money wages, that all the money is spent for direct consumption. It is often convenient to distinguish between money rents and produce rents. In this case also it is usually assumed that the actual produce rent is all turned into money. But in the one case money wages may be saved and in the other produce may be directly consumed.

In conclusion, it may be observed that the distinction between nominal and real incomes, whether national or particular, is always of importance, and a transition must never be made from one meaning to the other without considering the essential differences.

It seems hardly necessary to point out that the distinc-

tion between the classes of income is only logical. The same person may have an income composed of every species of revenue to which economists have given names.[1]

[1] It has been found necessary to omit the subject-matter of *Principles*, Book II, Chaps. VI–IX on "Village Communities," "Feudalism," "Contracts for the Hire of Land," and "Modern Ownership of Land." On the influence of competition and custom in the distribution of land: Seebohm, *English Village Community; Systems of Land Tenure* (Cobden Club); Field, *Systems of Landholding;* and on the general question: Mill, *Principles*, Book II, Chaps. III and IV and Book IV, Chaps. III and VII, sec. 7; Sidgwick, *Principles*, Book II, Chaps. I and XII; Marshall, *Principles*, Book II, Chap. IV, and Book VI, Chaps. I and II; Cannan, *Production and Distribution*, Chaps. VI–VIII; Smart, *Distribution of Income.*

CHAPTER VI

WAGES AND THE GENERAL RATE OF WAGES

1. Wages as the Real Reward of a Quantity of Labour. — Wages, like labour, may be regarded from two points of view, subjective and objective. By wages from the subjective point of view we mean, in the more familiar language of Adam Smith, the reward for laying down so much ease and happiness; or, in the more precise language of to-day, the utility that accrues to the labourer in return for the disutility of his toil.

If we reckon the reward simply in terms of money, the wages are called *nominal;* if we go behind the money and consider what it will purchase, and if we also take into account all the other desirable things the worker obtains in return for his toil, we arrive at the conception of *real* wages.

In either sense — whether we take nominal or real wages — the correlative term is a *quantity of labour.* In nominal wages, as a rule, the only element considered in the quantity of labour is the *time;* the money wages are calculated by the hour, day, week, or year, as the case may be. From the point of view of labour with which alone we are at present concerned, the year is the best unit of time to take in estimating the money or nominal earnings, though the bargain may be struck by the hour or the day.

In estimating the real wages that correspond to a certain amount of money wages, and taking as the unit of time the year, we have to consider a number of variable elements.

2. Real as compared with Nominal Wages. — *First*, as regards the *quantity of labour* involved in the course of the year, we must consider how the time is distributed. The work may be uncertain and irregular; it may vary between periods of great intensity and periods of enforced idleness. Other things being the same, the same money wages per annum will mean greater or less real wages, according to the quantity of labour involved; at one extreme a person might pay so much for permission to perform labour which in itself gives positive utility (or the nominal wages are negative); at the other extreme the nominal wages would not balance the disutility involved in the labour, and enough will not be obtainable without compulsion. An author who publishes a book at his own expense generally gets negative wages for his labour, whilst an adequate supply of soldiers may need conscription.

Secondly, as regards the reward obtained, we have to consider variations in the purchasing power of the money. A certain amount of annual money earnings varies from time to time and from place to place in its purchasing power. These variations may be due to general causes (examined later in the theory of money and prices), or to special causes of a local or temporary character. In the course of economic progress the prices of commodities that are easily transported tend to become uniform throughout a country; but there are always variations in some things, *e.g.* house rents. Movements of prices from year to year are also less violent than formerly, but we can still distin-

guish between dear and cheap years as regards important articles of consumption. This suggests another point. It is maintained that the material prosperity of the working classes can be measured by the proportion of their income spent on food, that is to say, the smaller the proportion the greater the prosperity (sometimes called Engel's law, though this is generally taken in the converse: the poorer the family the more spent on food). It follows that, other things being the same, a fall in the price of food, or more generally of necessaries, has more effect on real wages than a fall in non-necessaries. In estimating real wages we must then always consider the distribution of the money earnings in the nature of the family budgets of the working classes.

Besides the annual money earnings of the head of the family by his ordinary employment, we must take account of the opportunities afforded for extra earnings by himself or the members of his family. It may be noted that for many purposes in estimating real wages it is best to take the family as the wage-earning unit.

Besides the money, we must also make allowance for any additional payments in kind or services. This factor is often of great importance in estimating the real wages of agricultural labour, especially at distant periods: thus there may be allowances of food, lodging, fuel, and clothing; there may be some share in the stock or produce, or the right to the use of land or common, etc.

Finally, for some purposes, it may be best to take as the unit of time not the year, but the average lifetime in the employment considered.

3. Wages as Payment for Work Done. — From the objec-

tive standpoint we have to consider wages as payment made for so much work done, *e.g.* raising so many foot pounds or rendering so much service. The quantity of labour (subjective) is now only of importance indirectly as affecting the efficiency of labour. To the employer, the first consideration is not what the labourer feels, but what he does: the cost of labour to the capitalist now takes the place in the wages question of real wages to the labourer.

By analogy, we must now take account not only of the money paid, but of everything the employer must provide in addition. The amount of work done, may be measured in different ways, of which a very complete account is given in the *Methods of Industrial Remuneration*, by D. F. Schloss. There are two principal methods of measuring the work done, and the corresponding wages are called *time*-wages and *piece*-wages. Even these two methods are not so distinct as at first sight may appear. In time-wages there is always a tacit or expressed condition that so much work measured by some other standard is to be done in the time; and conversely in piece-work limits of time are always imposed within which the work must be done. When the time in which the task or a definite minimum must be performed is fixed, the wages are called *task*-wages. The difference, between these species depends on the adjustment of the emphasis as is usually the case with economic conceptions and classes. Thus even in domestic service, where there is no vendible product, there are implied conditions as to the amount and kind of service to be rendered in a certain time. Although the illustrations following the usual practice have been taken from com-

mon or manual labour, the same ideas may be applied to the highest forms of labour in the economic sense. Thus the professional man must also consider the cost of living as well as the amount of the fees or salary obtained in a year, and *mutatis mutandis* he must allow for all sorts of disutilities and utilities.

There are the same distinctions also from the objective standpoint. Payment may be made to the professional man by the employer by time or piece or task.

Perhaps the most striking point of contrast between manual and professional labour is that in the former case one employer has many workers, in the latter one worker has several employers.

The wide extension of the terms *labour* and *wages* in economics is one of the difficulties in attaching an accurate meaning to the expression, *a general rate of wages.*

4. The General Rate of Wages. — It is stated by Professor Marshall: "Such phrases as the general rate of wages or the wages of labour in general are convenient in a broad view of distribution, and especially when we are considering the general relations of labour and capital. But, in fact, there is no such thing in modern civilisation as a general rate of wages. Each of a hundred or more groups of workers has its own wage problem, its own special causes, natural and artificial, controlling the supply price, and limiting the number of its members; each has its own demand price governed by the use that other agents of production have of its services." It is of course true that there is no such thing as a uniform rate of wages at any time. In a great industrial country there are thousands of occupations in which there are

different rates of wages; and even in the same industry and the same department of it there are often differences, *e.g.* in agricultural wages in different counties in England. All economists, however, have admitted that there are such differences, and have tried to explain them; but most of them have also used this conception of a general rate, and have sought to explain movements in the general rate as distinct from these movements in particular occupations that are due to changes in the particular demand and supply or to changes in the quasi-permanent causes of difference.

In truth, precisely the same ideas and the same difficulties appear in dealing with the general rate of wages as in dealing with the wider conception of the general level of prices. As will be shown in detail in the theory of money and prices, we distinguish between general and relative prices; there may be great changes in the general level of prices, whilst the relative values of commodities *inter se* remain undisturbed.

Similarly, it is maintained that there may be changes in the general rate of wages without any corresponding disturbance of relative wages.

But changes in the general rate of wages do not refer to any change in the value of money; the changes referred to are real changes. Broadly speaking, a rise in the general rate of wages means that throughout the whole range of labour the real reward rises. If, for example, the prices of commodities, which are of importance in workmen's budgets, remain the same, but on the whole money wages rise (measured in the same way at the two dates), there is said to be a rise in the general rate.

As a rule, in any great industrial country, changes are constantly taking place in the actual rates of wages paid in the particular occupations. Accordingly, the movements in the general rate can only be discovered by taking averages of fairly representative types.

In either case it is assumed that there are certain causes at work of a general character that operate through the whole range of industry. In any particular case the effect of these general causes may be hidden by some particular change in the conditions affecting the kind of labour concerned. But it is assumed that these particular changes will be small compared to the great mass, that the changes will to some extent also counteract one another, and that beneath the particular changes the influence of the general causes can be discovered.

To begin with, indeed, we are concerned simply with a question of measurement. If it is found that whilst on the whole the ratios of relative wages are much the same, but that on the average every kind of labour obtains more money, and that there has been no corresponding rise in prices (possibly, indeed, prices may have moved in the opposite way), then the *fact* of the general rise is established, although opinions may differ as to the *causes* of the rise. We have records of wages both for England and France extending over several centuries (Rogers and Vicomte d'Avenal); and although the records are imperfect, and there have been errors in calculating the averages, there can be no question that there are discoverable changes in the general rate. And during the last fifty years there have also been remarkable changes in the general rates of wages in the great industrial countries.

Thus in a paper by Mr. A. L. Bowley, on wages in the United Kingdom in the nineteenth century, it is said, "In 1891 a million men, women, and children earned per head 40 per cent more in actual coin and 92 per cent more real wages, if the increased purchasing power of money is allowed for, than their million predecessors in the same trades in 1860." If it is assumed that this million of workers is fairly representative, the fact of a great rise in the general rate is established to whatever cause or causes it may be assigned. There are no doubt many practical difficulties in comparing different times: the conditions of work change, skilled labour may give place to machinery, new processes may be created, etc., so that though we compare the same names, we do not perhaps compare exactly the same things. New industries also arise and old industries disappear, and thus the trades chosen may not be fairly representative. There are also difficulties as regards the quotations and their interpretation.

Precisely similar difficulties, however, appear in all general estimates or averages in progressive societies, *e.g.* the growth of foreign trade.

The conception of a general rate may also be of use in comparing different countries at the same time instead of the same country at different times. If when we take representative industries of a similar character we find that in one country the average is higher or lower, we argue from the samples to the whole, and the validity of the conclusion depends on the assumption that there are general causes at work, and that the samples are fairly representative. A general rise in the rate of wages has taken place in the United Kingdom, the United States, and

France to about the same extent in each, comparing 1844–1853 with 1891. It is not implied that the general rates in the respective countries are the same at either period, but only that the rise in each case has been nearly the same.

These examples are of course only illustrative, but at any rate they raise the presumption that there are certain very general causes that affect all kinds of wages.

One more difficulty, however, may be noticed. In the examples taken for illustration the references are to wages of labour in the common and narrow sense of the term. Are we to assume that they are causes of such a general character that they will affect wages in the professions and also the wages of superintendence or management that form so large a part of gross profits? An affirmative answer is suggested by two considerations: *first*, there seem to be comparatively stable ratios between the wages of different kinds of labour from the highest to the lowest, and these differences depend on comparatively general causes; and, *secondly*, if these ratios are to be preserved, any movement that affects the mass of the lower grades may be expected, by what is conveniently called sympathy, to affect also the higher grades. There are no doubt great difficulties in passing directly from one group to another, even in the same grade, and still greater when different kinds of employment are compared, and this sympathetic action must not be exaggerated.

The question cannot, however, be adequately answered until the theories have been examined which profess to give the causes of movements in the general rates. It may appear that some of these causes are such as to operate throughout the whole range of industry, whilst

others may be such as to act differently in the higher and the lower grades of labour.[1]

And even as regard the lower grades of labour there are, it will be found, differences of a vital character so far as some of the general causes are concerned, *e.g.* the largest class of all (servants of all kinds) do not produce vendible articles. Thus their wages are not directly affected by the amount produced or by the price obtained for the product; both of these factors, however, are considered of the greatest importance in industries which afford material products and not temporary or perishable services.

We may now examine the theories that have been advanced to explain the causes of general wages and of movements in general wages. The first is the celebrated *Wages Fund* theory.

5. The Wages Fund Theory. — The wages fund theory is of interest to the student in three ways: for its place in the history of economic thought; from its influence on popular opinion and thus indirectly on practical labour questions, and because properly guarded it may still be considered as a first approximation to an adequate theory of general wages. In this place the attention must be confined to the third of these topics.

The theory is correct in that it calls attention to certain real causes affecting wages; but it is partly incorrect and

[1] The difference between the higher and the lower grades of labour is often exaggerated because people take the average of the lower grades, but only the exceptions (who obtain extraordinary earnings) in the higher. Thus taking all those employed in law, medicine, education, business, etc., the average earnings may not be much above artisans. The same increase of wealth which increases the demand for the labour of masons, etc., increases also that for doctors, lawyers, etc.

partly incomplete because it lays too much stress on these causes and takes no notice of others that are sometimes of even greater importance.

Stated so as not to be a mere truism or verbal statement of the problem to be solved, the theory may be expanded into three propositions: —

(1) In any country at any time there is a determinate amount of capital to be devoted *unconditionally* to the payment of labour. This is the wages fund; it is the effective *demand* for labour.

(2) In any country at any time there is a determinate number of labourers who must work *independently* of the rate of wages. This is the *supply* of labour.

(3) The fund is distributed amongst the labourers under the influence of competition. In the labour *market* competition is the ruling force.

The theory as stated, even in this expanded form, is plainly an example of the deductive or abstract method. Accordingly it is necessary to apply the test of verification.

In some cases it seems to explain the facts in a satisfactory way; in others it fails partially or completely.

The great rise in wages after the Black Death (which is properly described by Seebohm as the watershed of economic history in the mediæval period) may be accounted for in terms of this theory. The population was halved; the demand for labour to till the ground, etc., was practically unaffected, and competition broke through the fetters of law and custom.

Again if we consider the general wages fund to be made up of smaller wages funds distributed over different localities, it seems also in many cases correct. If any part of

a country is overpeopled (congested) relatively to the demand for labour (or the fund seeking to purchase labour), the rate of wages is low. Similarly, if we take particular employments in place of localities if a trade is overstocked with people and understocked with capital, wages are low. The converse is also true of places and trades. These references to particular wages funds may be brought under the general theory under review more formally by the assumption that in the first case we are dealing with a small country, and in the second with a country in which there is only one main employment (as agriculture in the mediæval period).

But when we turn to other facts, the theory seems to fail or at best only to explain the facts by being twisted from its natural interpretation. Thus a population may be decreasing rapidly without any corresponding effect on wages; in Ireland from 1848 to 1851 (when a million people left the country), in spite of the fall in the supply of labour the rate of wages actually fell. Similarly, there may be a rapid increase in capital without a corresponding increase in population, and wages may not rise as was constantly illustrated in the early part of the nineteenth century. One of the most striking failures of the theory (unless unduly strained) is in the high wages current in new countries in which, as a rule, there is a rapidly increasing population and a marked deficiency of capital. And in old countries we often find that there is what is called a glut of capital with no increase of population coincident with a fall in wages, as in a depression of trade after an inflation and crisis.

In the light of this apparent conflict of facts it is neces-

sary to examine the theory again to discover the disturbing causes. The *first* proposition, that there is an amount of capital destined to be given *unconditionally* to the payment of labour, is clearly overstated, although stress must be laid on this term if we are to avoid the barren verbalism that the wages fund is equal to the sum actually paid in wages. If we consider the great staple industries in which the capital is employed in the production of material commodities for sale, it is plain that the owners or employers of the capital will adjust their demand for labour partly at any rate by the actual and expected profit, which again depends proximately on the course of prices. This close connection of wages with prices is so well recognised that in many cases the principle of a sliding scale has been adopted, the wages being adjusted to movements in prices automatically or by reference to authority for the precise determination.

Again, if we consider the other great class of ordinary labour, namely, servants, it is not correct to say that the employers set aside a certain portion of their means unconditionally for this purpose; they consider what they can get, and what they can do without, when they compare this mode with other modes of expenditure. Similarly, if we take the demand for the labour of the professional classes, — doctors, lawyers, singers, clergymen, etc., — there is again a debatable margin.

But, as so often insisted on already, although in all economic conceptions there are debatable margins, the conceptions are still workable. And in these examples we discover that there is an element of truth offered by the wages fund theory by way of explanation. In manufac-

tures and the like the existence of a certain amount of fixed and specialised capital involves the continuous application of a certain amount of labour; works may even be run at a loss for a time in order not to disorganise the business. Again there is a quasi-necessary demand for services of all kinds, — from that of doctors and nurses, who may be necessary to save life, to that of domestics, who are thought necessary for comfort or fashion.

It may also be objected to the capital element in the wages fund theory that the idea of a fund — preaccumulated and predetermined — is out of place. The harvest of a simple state of society does not fairly represent modern industries. We have a continuous stream of products. Part of this stream is devoted to labour. Still even here it may be replied that a large part of this stream of products may be called circulating productive capital, and consists of things adapted and only adapted for the consumption of the masses, that is to say, of the labouring classes as a whole. And in truth more broadly all the productive powers of the country at any time are devoted to providing for the wants of the nation according to the actual distribution of wealth. It would obviously be impossible to turn the capital invested in the production of things on a large scale for thousands and millions to the production of luxuries for the wealthy owners of mines, factories, etc. In a broad sense, but also a very true sense, a large part of the productive capital of a country is devoted to the provision of things of use only to labour, and these real things must be so used or not used at all. The latter alternative may be taken under certain conditions (Fourier), and more frequently the things once produced may no longer

be produced, but then in either case the wages fund may be said to diminish.

The *second* proposition as regards the number of labourers is in general much nearer the truth and the whole truth than the former. Still even here, as is shown by the returns of the employment of labour, by the fluctuations in pauperism, by strikes to prevent a fall in wages, etc., there is always a debatable margin; it is not true to say that labour must work independently of the rate.

It is perhaps to the *third* proposition that in recent economic books most exception has been taken; namely, the proposition which declares that the wages fund is distributed by *competition*. Competition may be considered positively and negatively. On the positive side competition implies that every person tries to attain his own economic interests regardless of the interests of others. Negatively it is implied that the self-interest is not attained by combination or by law or by custom. Competition also implies, if perfect, that each person knows his own interests and that there is perfect mobility of labour. If this is a fair account of what is to be understood by competition in the wages fund theory, it is clear that in practice it is liable to be modified by disturbing causes. Thus there is at present the influence of combinations both of employers and employed, and especially when real wages are taken there is still considerable influence on the part of law. Custom also imposes many obstacles to the passing of labour from group to group, and in some cases influences directly the rate of wages (as in the case of women). At the same time, however, competition is sometimes concealed, though really at work. Custom is often a form of slowly

moving competition (Marshall), and within the combinations of labour and capital the law of substitution (Marshall) is a form of competition.

6. The Produce Theory of Wages. — In trying to bring out as far as possible the elements of truth contained in the wages fund theory, to some extent the opposing theory (the produce theory) has been anticipated. It may be well then to state definitely first of all the points in which the two theories are most opposed. The wages *fund* is supposed to be preaccumulated, and predetermined in its amount and its application. (The student later on will see that in the quantity theory of money in its simplest form the amount of money is similarly fixed and it must all be circulated.) In the produce theory stress is laid on the fact that wages are paid out of a *continuous stream*, and not out of a fund, stored up it may be a long time before. In this later theory it is also assumed that the amount of the flow of wealth devoted to labour will depend partly on forces that cannot be summed up under competition.

If we suppose that the real national income or flow of wealth is divided into rent, wages, and profits, it is clear that the amount of any one will depend first on the amount of the total stream, and next on what is taken by the other two. If we leave for future consideration rent which is of the nature of a surplus, and the revenues of government which are taken by compulsion, we have left the aggregate earnings to be divided between labour and capital. Here we are again met by the difficulties of definition and classification which have so often been noticed before.

It seems best, then, in the first place, to narrow the

term *wages* to the earnings of labour in industries which yield vendible products, *e.g.* manufactures. The so-called wages of management are placed under profits, and the profits of the employers are opposed on this view to the wages of their employees.

Speaking broadly, the distribution between wages and profits (as now defined) will depend on the relative strength of capital and labour. This relative strength again will depend on various elements. The first may be called the intensity of the reciprocal demand of labour and capital for their mutual services. This brings in under another aspect the competition element on which the older theory lays so much stress. If capital increases, labour, being the same, the owners of capital compete for labour to a greater degree and so far wages rise. And more generally, in response to changes in the relative proportions of labour and capital, wages rise or fall or remain steady. (All these cases are worked out in detail in Mill, Book IV, Chap. III — a survey which Marshall thinks is the necessary complement to the wages fund, and not so misleading.) But on the modern view this reciprocal demand is not sufficient. The relative strength may be affected directly by the influence of law and custom. In former times these influences were largely on the side of capital. Thus wages were lower than they would have been if perfect competition had prevailed. On the side of capital there was open or tacit combination to keep down wages, with no corresponding combination on the side of labour, and in effect capital had a buyer's monopoly.

At present the influence of law affects wages in favour

of the workers indirectly, and is best considered by taking the elements in real wages. Thus, legislation may improve the conditions of work; it may prevent truck in some cases, and in others insist on a certain quantity of food, etc., being provided (sailors); it may affect the kind of house accommodation, sanitation, education, etc. Compulsory compensation may be awarded in case of injury received in the employment, and the hours of labour may be limited. The example of some of our colonies shows that compulsory arbitration may be adopted, and in this case the wages are supposed to move between limits. The old allowance system was apparently intended to enforce the principle of a legal minimum or "living wage," though the standard was on a comparatively low scale. These and similar objects, when not attained by law, are aimed at by trade unions, which may be brought logically under custom. (See below, Chap. IX.)

But although in this case especially the wages fund theory must be modified and supplemented, the causes indicated in that theory are always real and always of importance. The amount of capital and the number of labourers are always of primary importance, and competition is more often overshadowed than displaced by the other influences noted.

The wages fund theory, however, naturally suggests that wages cannot be directly benefited as in the case of improvements, etc., except first of all more capital is *saved*. The produce theory, on the other hand, naturally suggests that the state of trade, the efficiency of labour, and all the factors that affect the real national income,

may benefit labour directly, if only labour, either through law or combination, can exercise its full strength in bargaining.

When the view of wages is extended, so as to cover the reward or the share in the real national income of all kinds of labour, then the produce theory as applied to manufactures appears too narrow. As regards servants and the professional classes, the demand for their services increases with the flow of national wealth, which is devoted to services in preference to consumable commodities or forms of productive capital. The supply of labour of this class depends partly on the general increase of population, and partly on the relative attractiveness of different employments. The distribution as between the great classes depends partly on influences that may be brought under competition, and partly on such as are logically considered under law and custom. [The causes of differences of wages in different employments are considered in the next chapter.] It is clear that these causes of relative differences have an effect on the so-called general rate if that term is narrowed down, as is often the case in the statement of the produce theory so as to include only the wages of those employed in material production for the profit of their employers (Walker). The large part of profits that is called wages of management is closely related to the earnings of the professions, and the wages of those employed in factories is related to the wages of domestic servants. We are not entitled to say more than that there is a mutual interaction between these various rates; we certainly cannot say that the rates in manufactures, mining, etc., are

first fixed, and then the other rates in the various "services" are fixed in proportion (Hadley).

7. General Relations of Wages to Profits and Rents. — So far we have considered the general causes affecting wages without introducing the other great species of incomes, profits and rents except indirectly. The changes in the relative proportions are properly considered under the effects of economic progress (see Book IV). Of course, as already observed, so long as the national income remains the same, the share of any one will depend on the proportionate shares of the other two. But the point of most interest and difficulty is in the indirect effect of a change in the proportions on the total income. Thus if either through the power of trade unions or the direct influence of socialistic legislation the share of capital were greatly reduced, the immediate effect might be a rise in wages (absolutely); but if the productive capital were to begin to dwindle owing to this fall in its share, the effect on the aggregate national income might be such that real wages would fall. Thus to take an extreme case the proportionate share of labour might continually increase until that original state of things was restored in which "the whole produce of labour belongs to the labourers." This is the state that, according to Adam Smith, precedes the appropriation of land and the accumulation of stock. It needs no showing, however, that in the *Saturnia regna* of history the real wages of labour were never so low, or, what is practically the same thing, the condition of the people so miserable.

Just as in foreign trade it is false to suppose that one nation must and can only gain if another loses, so also in

the exchange of the services of the great productive agents and of the various industrial groups it is false to suppose that mutual injury is the source of benefit.

There are no doubt points of conflict between the interests of labour and capital, and what one loses the other will gain; but there are also points of harmony. And so far as distribution can be considered as based on exchange, the leading idea must be one of mutual benefit. These points will call for further attention after the examination of profits. (See below, Chap. IX.)[1]

[1] All the text-books treat largely of general wages. The treatment in Adam Smith contains in germ both the later theories, and may well be taken as a beginning. Malthus, *Essay on Population*, Book III, Chap. V, Book IV, Chap. III. Mill's chapters on *Popular Remedies for Low Wages* and his own remedies show the real meaning of the wages fund theory and that as stated by Mill it needed modification. Sidgwick's chapter on the *General Rate of Wages* (*Principles*, Book II, Chap. VIII) may be taken next, and then Marshall's chapters on the relations of distribution and exchange, *Principles*, Book VI, Chaps. I and II. Special works are: Walker, *Wages Question*; Taussig, *Wages and Capital*; Davidson, *The Bargain Theory of Wages*; Nicholson, *Effects of Machinery on Wages*; Smart, *Distribution of Income*; J. B. Clark, *Distribution of Wealth*; Cannan, *Theories of Production and Distribution*; Schloss, *Methods of Industrial Remuneration*; Webb, *Industrial Democracy*.

CHAPTER VII

RELATIVE WAGES

1. Differences of Wages. — Experience shows that there are at any time differences in the rates of wages actually paid whatever measure is adopted; and a number of particular causes of difference have been pointed out by economists, the lines of treatment of Adam Smith in a famous chapter being generally followed. It seems best, however, in this summary, to begin with the most general causes and conditions by which these particular influences may be explained.

Wages as already shown must always be considered from two points of view. On the subjective side the labourer will take into account all the utilities and disutilities involved in the work, and in what is obtained from expending the money received, and any extra earnings. If competition were perfect, and all the conditions requisite to mobility of labour were forthcoming, the net advantages of all employments would tend to equality. Thus extra disutilities of any kind would be compensated by extra wages; and conversely, if the work itself had positive utility, it would command so far less wages. In this way we may take account of such natural causes of differences as are enumerated by Adam Smith, *e.g.* the agreeableness or disagreeableness of the employment; the easiness or the reverse in learning the business (the greater

the trouble, the greater the disutility); the regularity of the employment, and the chance of success or the reverse.

This tendency to equality, however, from the subjective side, is, like all other economic tendencies, liable to be counteracted. The causes indicated are only part of those that affect the *supply* of labour in the different employments; and in addition there are all the causes affecting the *demand* for particular kinds of labour.

The introduction of *demand* involves the consideration of labour from the objective point of view. Here we have to take account of the fact that different degrees of abilities, natural and acquired, are demanded in different employments. Thus, a long training not only involves more disutility (subjective), but also greater expense. It is only those who have the means who can train themselves or their children for these more exacting employments. Sometimes exceptional natural qualities are needed, — it may be of intellect, or keenness of sense, or even morality (*e.g.* the greater or less trust pointed out by Adam Smith).

Again, the work required to be done may be done in different ways: by a small amount of highly efficient labour or by a much greater amount of less efficient labour. From the point of view of demand, it is indifferent to the employer what method is adopted so long as the cost is the same. It is clear, however, that the more efficient the labour, so much the higher may be the pay.

Thus on the objective side we arrive at the proposition that *equal efficiency tends to be paid for at equal rates;*

and so far as competition is effective, equal degrees of skill should command the same price.

It is evident that when we are comparing different employments it is not easy to estimate the amount of skill required; it is, however, certainly taken account of whenever any substitution is possible.

Besides these natural causes that affect the demand for and the supply of labour under the assumption of perfect competition and mobility, there are actually all the causes which render these conditions imperfect.

Here the general principle is that anything that modifies competition or mobility so far modifies wages. Adam Smith pointed out that "the policy of Europe" in some employments had unduly restrained competition, *e.g.* the regulations of gilds and corporations by restricting entrances; in some occupations the competition had been unduly increased, *e.g.* the church, education, and literature, through charitable endowments; in other cases, the natural passage of labour from place to place and from trade to trade had been hindered, *e.g.* by the ill-contrived law of settlements; and sometimes the law had directly intervened to fix wages in certain employments.

The general result of all these influences, both natural and artificial, is that there is practically a special wages problem in every group (Marshall). Whilst this is admitted, at the same time it appears that the general causes noticed in the last chapter are always at work; and thus we may have movements in the general level of wages, the *ratios* between the different employments remaining relatively constant or only changing in response to particular causes. (For examples, see below,

Book IV.) If in any group having regard both to disutility involved and efficiency required the rate of wages is above or below this general rate, it will be unstable and causes will come into play that will tend to bring it toward its natural or normal rate. The influence of the natural causes may of course be counteracted by the artificial effects of law and custom in various forms.

2. Particular Cases. — One or two particular cases may be noticed which illustrate the argument of the last section. It is often found that the most disagreeable employments are the worst paid (the evil paradox of Professor Marshall). From the side of supply this is explained by the fact that the labourers have no choice: they are the dregs of the people; from the point of view of demand their labour is extremely inefficient, but it may be so cheap as to cost even less than more efficient but higher priced labour. The wages in agriculture have generally been lower than would be indicated by an estimate of the skill required and the hardships, etc., endured. This seems accounted for by the fact that the supply naturally increases, whilst the demand either remains steady or even falls. Thus for centuries there has been a movement of labour from the country without the "natural" proportion being attained.

The wages of women are in most cases lower than those obtained by men for work of similar difficulty and disutility. The main reason is that the employments open to women are restricted by custom.

The case of those who have other means of support is of interest, *e.g.* peasant proprietors and other small landholders. A peasant who is already sure of a liveli-

hood can refuse to work for wages in his spare time and may set a high reserve price on his labour. On the other hand, he may set a low value on his spare time and on leisure, and may be keen to earn a little money for luxuries. Mill accounted for the high wages current on the continent for any supplementary work by the first principle, whilst Adam Smith gives examples from Scotland of extra work being done by cottars for very small remuneration. In modern phraseology the marginal utility of money was higher in Scotland than in France.

If an industry is declining, the rate of wages falls below the average, owing to the want of mobility of labour, *e.g.* the hand-loom weavers. On the other hand, a new industry offers more wages to attract labour, and it is the more enterprising and efficient labour that is attracted, and thus the rate of wages may be for some time above the general level for the class of work.

Again, any sudden rise in the demand for labour in an old occupation raises the rate of wages until the supply can be adjusted. In such cases as this the differential wage may be described as a quasi-rent (Marshall). The rise in the demand for labour may be in the direct demand, *e.g.* for servants; or in the *derived* demand (Marshall), *i.e.* derived from the demand for the commodity to which the labour in question contributes.

With the extension of the principle of association or combination, both the sellers and the buyers of labour try to substitute monopoly for competition. If a large trust has the practical command of a group of industries, it may be able to establish a buyer's monopoly and even

refuse to deal with combinations of labour; and, conversely, a strong trade union against divided or keenly competing masters may establish a seller's monopoly. The rate of wages will tend, in the first case, to be below, and in the second above, the natural rate. The limits of the rise and fall can, however, only be explained after the theory of monopoly value.

3. Wages of Individuals.—We have now considered the causes that affect the general rate of wages throughout an industrial country, and the causes that give rise to differences of wages in different employments. In both cases we have been concerned with averages, and for fuller treatment the student should refer to works on statistics (*e.g.* A. L. Bowley). The general result is that differences in the general rate and differences between the rates in different employments are under the influence of economic laws or tendencies of a more or less general character.

When, however, we turn to individuals, we notice such differences in extreme cases that they seem to elude any general explanation, *e.g.* the wages of the most successful lawyers or doctors or singers, etc. In the first place it must be observed that if the professions in question employ a large number of persons, in spite of the high wages obtained in some cases, the average may be low, having regard to usual causes of differences. Thus the average earnings of actors are probably below those of carpenters, in spite of the large sums earned in special cases. In these exceptional individual cases the high pay is explained on the principles of scarcity value. The exceptional demand is not for actors, but for Duse or Bernhardt.

The scarcity factor explains both the high fees of the fashionable doctor (who by the testimony of his colleagues is no better than a hundred others), and also the high fees paid for really exceptional skill.

In other cases, however, the differences in the rates of pay are accounted for on the principles of rent. If the marginal labourer earns so much, the more efficient labourers will earn so much more in proportion to their extra efficiency.

4. The Effects of Machinery on Wages.—As illustrating the principles involved in the wages question, some of the effects of machinery on wages may be briefly noticed.

The sudden and extensive adoption of labour-saving machinery so far tends to throw labour out of employment. There is immediately a less demand, whilst the supply remains for the time the same, and wages fall. Such sudden and extensive substitution are, however, rare. A revolutionary idea takes a long time for its full development in practice, and thus there is time for the gradual withdrawal of labour. If, however, the labour concerned by habit or necessity still competes with the machinery, the wages must fall, and until this is effected the machinery earns a *quasi*-rent.

On the other hand, as the use of the machinery is extended, the price of the article falls, and it is possible that the consequent extension of the market may eventually lead to an increase of employment and a rise of wages in the industry concerned (Cotton). The proximate cause of the adoption of machinery is the hope of extra profit, and part of this extra profit will be invested in the demand for more labour in some form.

Generally the use of machinery means increased power over nature and a greater return to the productive agents of the society. The rise in the national dividend so far tends to raise the general rate of wages. Since also, on the whole, a much greater amount of skill is required on the part of labour under a régime of machinery, wages so far will tend to rise. (See my essay on the *Effects of Machinery on Wages.*)

5. Conclusion.—In conclusion it may be observed that in treating of wages it has been necessary to anticipate to some extent ideas and principles that are more fully investigated at a later stage (theory of rent, value, etc.). Anticipation of this kind is, however, necessary, whatever the order of exposition chosen. If we begin with value, we must anticipate to some extent wages and profits. The statement, "that the value of labour must be determined by the value of the produce, not the value of the produce by that of the labour," is far too narrow unless the term *produce* is extended to cover services of all kinds, and the sentence is interpreted to mean that the value of labour depends not only on subjective feelings, but on objective results.[1]

[1] Book II, Chap. XII, of *Principles* deals with the effects of law and custom on wages from the historical side. See *Wealth of Nations*, Book I, Chap. X, still the most suggestive treatment; Hadley, *Economics*, Chaps. X and XI; Marshall, *Principles*, Book VI, Chaps. III–VI; and the works cited in the last chapter; Sidgwick, *Principles*, Book. II, Chap. IX; Pierson, *Principles of Economics* (Eng. trans.) Part I, Chap. VI, §§ 6, 8; also on effects of machinery, Hobson, *Evolution of Modern Capitalism*. In Book IV, Chap. VII, of my *Principles* (Vol. III) a number of examples are given of *ratios* of wages.

CHAPTER VIII

PROFITS

1. Analysis of Profits. — "The profits of stock, it may perhaps be thought, are only a different name for the wages of a particular sort of labour — the labour of inspection or direction. They are, however, altogether different, are regulated by quite different principles and bear no proportion to the quantity hardship or the ingenuity of this supposed labour of inspection and direction" (Adam Smith). Most economists, however, have not followed Adam Smith in excluding from profits this form of wages. Thus Marshall, "What remains of his profits after deducting interest at the current rate (allowing, where necessary, for insurance), may be called his earnings of management."

From the business point of view it is usually said that profit is the excess of the money return over the money cost. But this statement explains nothing, and the question still remains: Why does a thing obtain more than its cost? That is to say, when all the parties to the production and acquisition are supposed to be fully alive to their own interests, and competition is assumed to be perfect.

To this question two main answers have been given which correspond *mutates mutandes* to the twofold treatment of wages; namely, subjective and objective. In the first answer it is said that, on the whole, the owners of capital must receive a sufficient reward for abstinence, an

indemnity for risk, and wages for the trouble of management; in brief, these three utilities must at least balance the three disutilities involved in the creation and employment of the capital.

The objection to this answer is that it only lays down the necessary conditions for the continuous *supply* of capital. So much, at least, must capital receive; but why not more?

The second answer looks to the utility, efficiency, or productive power of the capital. It assumes that capital is one of the agents that contribute to the national income, and the owners exchange its services against the services of the other agents, *e.g.* labour of all kinds. From this point of view profits depend on the *demand* for, as much as on the supply of, capital. The demand for capital may increase, the supply remaining the same, in which case the profits will rise independently of any extra exertion on the part of the owners of capital.

The principal use of the first analysis is not to give any ethical justification of profits, but to show that the term includes different elements that depend on different causes. These elements will be examined in order.

2. Loan-interest and Profit-interest. — The simplest form of profit is the interest derived from capital lent on perfect security and without any trouble on the part of the lender, *e.g.* when an old lady instructs her banker to put her dividends on deposit receipt, or her broker to invest in more consols. To explain this form of interest it is not necessary to carry the analysis very far. The old lady has the command of money, and other people wish to get the command of money immediately. For this privilege of immediate

use they are willing to promise more money in the future; so long as repayment of the principal is deferred, the sum agreed on for its use will be paid. The history of the development of this simple form of loan-interest is most instructive, especially in connection with the legal and moral aspects of *usury* on money. From the earliest times, however, usury (the old name for interest) was obtained on all sorts of things, — "usury of victuals, usury of anything that is lent upon usury." And in modern industrial societies the money that is borrowed at interest is in general only the means for the acquisition of "things." (The case in which the money is required as such, *e.g.* to meet prior monetary obligations, is treated separately at a later stage.) Thus a man may borrow money to buy a house to live in, or to buy machinery to work his land, and the money he obtains from the bank for the purpose may not even leave the bank. The security afforded may also be, for all practical purposes, perfect.

Money may of course be lent without interest (as by the Jew to his brother) on various moral grounds, but apart from these cases it is important to notice that even in commercial transactions in which no altruism is present, interest in certain cases may be *nil* or even negative. Under present conditions the banks hold, on the whole, large sums of money without interest, *e.g.* the balances of current accounts. In the origins of banking it was not uncommon for the depositors to pay something for safe custody. As soon as we pass from money to things, negative interest in particular cases becomes quite common; *e.g.* a business may be run at a loss, and a creditor may bear some of the loss, and even send good money after bad

to provide more capital, in the hope that ultimately the negative interest may be balanced by future gains.

Leaving for the present the element of risk, we may next observe that although, on the whole, in modern commercial transactions loans of money and of capital in other forms yield interest, it by no means follows that money or capital, if not lent, will also yield interest.

Money itself is obviously as barren now, as the wisdom of the Bible and Aristotle declared it to be in old times. And although it is usual to reckon that part of the profits of a business that corresponds to the current rate of interest as interest on the capital invested in the business, it is clear that this profit-interest, as it may be termed, is on quite a different footing from loan-interest. The mere fact of the *employment* of capital does not assure interest to the employer any more than the mere *possession* of capital assures interest to the possessor. The interest on production-capital must be earned; that is to say, it must be produced out of the sale of products above the price of the other elements of cost.

Passing from particular cases, which are only of use to clarify ideas, it is possible, even when we take a country as a whole, that after allowing for the other elements in profits, the rate of profit-interest may fall far below the level of loan-interest. Loan-interest may be obtained from abroad or from taxes; but the capital of a country, already fixed and specialised, cannot be sent abroad or advanced to the state. In the course of time, however, the absence of interest would affect the national production-capital, as it does that of a particular trade, and on the capital left interest will again arise.

It may be thought that capital, as a whole, would refuse to lend its services to labour as a whole, unless it obtained interest. But no such combination of capital can exist under competition, and even if there were a perfect monopoly on the part of capital, interest as such might not be forthcoming. Under certain conditions even monopolists may have to sell at a loss.

In modern industrial countries, however, it may be easily shown that the capital invested in productive undertakings as a whole does yield interest over and above insurance for depreciation and wages of management, — namely, by reference to the growth of joint stock enterprise. In industrial companies, as a rule, the interest element can be taken separately, and such undertakings on the whole yield profit-interest that corresponds to the current loan-interest, besides the other elements of profits. The tendency of all modern industry is to work more and more with borrowed capital.

3. Insurance against Risk. — The element of risk may first of all be considered in the case of *loan*-interest. "High interest means bad security;" it is, however, generally assumed that a number of risky securities may on the average give a perfectly safe return. Whether this is actually the case in any society at any time or over a series of years, depends on the resultant of conflicting causes. If we take as representative of loans the investments of the public in stock exchange securities, it appears that the chance of high gains is generally as much overestimated as in ordinary gambling.

All, then, that we are entitled to say, is that there is a tendency to equality in *loan*-interest proper, after allow-

ance is made for risk; and like all other economic tendencies it is liable to be counteracted.

When we turn to risk as it is found in *profit*-interest, the difficulties of computation increase and the tendency to equality is subject to more disturbing elements. In some trades the risk element can be partially separated and allowed for by way of insurance; *e.g.* in shipping, both ship and cargo may be insured; but there is no insurance against the loss through a fall in freights or a lack of orders. Risks of this kind can only be met by a higher profit in good years to balance the losses of the lean years. It is impossible to determine by any general principle whether on the whole the uncertain trades will effect their own insurance. There may be great risk to individuals in a trade and little risk to the aggregate capital employed in that trade, as shown in the history of banking. In some cases, however, there may be a continuous loss of capital on the whole, which is only made good from other funds, as is well illustrated in many mining industries. No one, it is said, can make money out of a Cornish mine but a Cornish man, and he only does so by selling it.

The risk factor has been surmounted in two ways in joint stock enterprise: investors have been able to divide their risks and thus apply the methods of insurance, and the principle of limited liability has made such a division of risks still more practicable and certain. It has sometimes been supposed that if the risks of capital are very great in any country, owing to general insecurity, a high return is necessary for accumulation to take place at all. But the truth rather is that insecurity checks the accumu-

lation of capital directly, and, taking a broad view, with general insecurity through bad government there is less to divide between capital and labour, and both may suffer at once. There is no effective insurance against the risks of a state of general insecurity. In such a state of things, when account is taken of all the losses of capital, the aggregate gross profit will not suffice to cover the actual depreciation, and the whole country becomes impoverished.

4. Wages of Management. — Capital to be continuously employed must yield something more than interest and compensation for risk. Otherwise every one would try to lend simply and get the same income without any trouble. As shown in economic history, this sometimes happens on a large scale and a whole nation becomes a lending state. When we take an isolated country, however, if many people try to lend instead of employing their capital in business, the rate of interest must fall, and in this way an encouragement will be again given to trade and production, and a margin will appear for wages of management.

The element of earnings of management as distinguished from other elements in gross profits is best seen in the case of joint stock companies. The debenture holders receive the pure interest; the deferred shareholders receive the reward for risk, not allowed for in actual insurance, and the managers and directors receive a kind of wages for the labour of inspection and direction.

In the case of companies these charges will be on the same footing as the other higher forms of wages.

The rates of remuneration of the managers will in general not be exactly proportioned to the magnitude of

the capital engaged. The larger the business no doubt the higher the manager will be paid, but in no definite proportion. If, instead of estimating earnings of management by the salaries supposed to be earned (say) in a year, we were to estimate them by the *rate per cent* of the capital engaged, this want of proportion becomes still more marked. It is the smallest businesses that always appear to pay the highest rates of profit, simply because the wages of management are so high relatively to the capital employed. The diminution of this expense is no doubt a strong factor in the tendency to amalgamation of all kinds of capital already examined.

Wages of management, taken strictly and separated from other elements in profits, are subject to the relative causes that determine the differences in other forms of wages (see last chapter). The special characteristics of the earnings of management have been admirably worked out by Professor Marshall.[1]

5. The Reward of Enterprise and Good Fortune. — There is an element in gross profits which cannot be properly placed under any of the three headings already noticed. It is so much the peculiar characteristic of profits that in certain cases it overshadows the rest. It is, in fact, the reward of enterprise and good fortune. Enterprise, in the highest forms, is a combination of exceptional ability with exceptional risk. The ability is of the kind that defies definition; it is analogous to the genius of the soldier as distinguished from the knowledge of the military student. It demands at the same time stubborn perseverance in what seems hopeless waste of energy

[1] *Principles*, Book IV, Chap. XII; Book VI, Chaps. VII and VIII.

and also the utmost readiness to adopt changes in response to the opportunities of good fortune. The risks in these exceptional cases may be far beyond those of any actual calculation: a man may risk the whole of his capital, and, besides, all that he can borrow on the chance or the hope of success. It is enterprise of this kind that has played the greatest part in economic progress; it is the necessary practical complement to the discoveries of the creative genius in science.

Enterprise of less degree but similar in kind may also appear in old-established industries, as in the adoption of better organisation, or improved processes, or minor economies. This element in profits is in some respects analogous to economic rent, in others to quasi-rent.[1]

6. The Tendency of Profits to Equality. — In the light of this analysis it is clear that we cannot speak of any general tendency of gross profits to equality, in the sense that, if we take a long enough period, the average gross profits on all employments of capital tend to be equal. All that we are entitled to say is, that if any of the elements in profits is above the average, having regard to the special causes of difference, such a rate is unstable (and conversely of low rates). In the case of interest (after allowing for risk) the instability of exceptional rates is felt most quickly; in management proper, exceptional rates of wages are also unstable, though the period of readjustment is longer; whilst, in the last element examined, namely enterprise, the exceptional gains will provoke imitation and competition,

[1] Cf. Marshall, *Principles* (4th ed.), p. 661 n.

but the exceptional reward of the first promoters will not be obtained by his followers. True enterprise, however, will appear again in other forms and places, and the knowledge that in former instances these great rewards have been obtained, will stimulate enterprise of all kinds. Good fortune in trade and in war, as the name implies, is not to be averaged.

Throughout this treatment of profits it has been assumed that competition is the prevailing influence. The exceptional gains derived from monopolies can only be explained after the theory of value.

7. The General Rate of Profits. — Since gross profits are analysed into elements that depend proximately on different causes (*e.g.* interest and wages), and are measured in different ways, it is not easy to form a conception of a general rate of profits. Interest measured *per cent* may be falling, whilst wages of management reckoned *per caput* may be rising. We can, however, easily form an idea of a general rate of interest, and of a general rate of wages of management when taken separately. Such conceptions are useful in the theory of value, and also in considering the nature and results of economic progress.

When we are considering the general distribution of wealth, we may, for certain purposes, put together the total earnings of capital, including interest, wages of management, and also the rewards of enterprise, and compare them with the earnings of labour, in the sense of ordinary manual labour; and with this interpretation we compare the aggregate earnings of capital and labour, and consider under what conditions the one may rise

at the expense of the other. Questions of this kind arise in dealing with socialism and also in treating of some of the ulterior effects of trade unions, coöperation, etc.[1]

[1] Marshall, *Principles*, Book IV, Chaps. XII and XIII; Book VI, Chaps. VI–VIII; Hadley, *Economics*, Chap. IX; Sidgwick, *Principles*, Book II, Chap. IX, § 3; Walker, *Political Economy;* Cannan, *Production and Distribution;* Pierson, *Principles*, Part I, Chap. V.

CHAPTER IX

HARMONIES AND CONFLICTS OF LABOUR AND CAPITAL

1. Relations of Labour and Capital in General. — In the present chapter the terms *labour* and *capital* will be taken in the restricted popular meaning; that is to say, labour is only that hired by the employer of production-capital with the view to a profit. The term *labour* is further restricted to ordinary labour, thus excluding the higher professional labour which is also hired by the undertakers of business, and also the various forms of the labour of direction and inspection.

As already shown in the analysis of wages, it is to the economic interest of the worker to give a minimum quantity of labour (subjective) for a maximum real reward; and it is to the interest of the employer to obtain a maximum of work (objective) at a minimum real cost to himself. Thus the elements of conflict are always present and are generally intensified by prejudice, and want of appreciation of the harmony of interests in many respects. To take the simplest case: the worker naturally wishes to work fewer hours a day for higher wages, whilst the employer would like more hours' work for less wages; the former is apt to forget that wages after a certain point must fall if hours are reduced, because the product must fall off, whilst the latter does not allow enough in many cases for the increased efficiency of shorter hours

and better pay. There are, however, in any case real divergences of interests; or, in the popular phrase, real conflicts of labour and capital.

2. Conflicts of Interests; Origin of Trade Unions. — There is not one of the elements that go to make up a "quantity of labour" that may not give rise to an apparent if not real conflict of interests; and this is equally true of the corresponding real reward.

During the nineteenth century the conflict of interests has been forcibly illustrated by the history of trade unions. With reference to this history, only the main lines of inquiry can here be indicated.

The connection of the trade unions with the craft gilds is one of analogy, not of descent. And the points of analogy must not be overstrained. The craft gilds in mediæval England did not originate, according to the view which Brentano had at one time made popular, from conflicts between labour and capital such as arise in modern times with large production. Nor is there much foundation for the wider contention of Brentano that the weak always resort to combination, and the strong to competition — witness the modern trust. The chief point to notice as regards the craft gilds, as bearing on trade unions, is that what was evil in them (and the chief cause of their decay) was due to the tendency to monopoly, which they soon revealed, and what was supposed to be of real public benefit was transferred from the gild regulations to the statute book (Statute of Apprenticeship, 1563). These regulations and the customs to which they gave expression dominated the wage system of the country until the industrial revolution.

When this customary order broke down, the relations of labour and capital became utterly disorganised, to the great detriment of the working classes; and it was to remedy these abuses that trade unions were formed. They were from the first associations of labour. The craft gilds in England, on the other hand, were local bodies under the local authority of the town, though at first they occasionally derived their authority from the king or lord of the manor. Their ostensible objects were to benefit the public by securing good work and materials, and the master was responsible for the good upbringing of his apprentices, who in turn might hope to become masters.

During the early years of the nineteenth century the trade unions were subject to severe legal restraints and disabilities, and in general were held up to popular odium by the press and those who sought to guide popular opinion; they were written down as anarchist secret societies that sought for the ruin of capital and industry. At present the pendulum has swung to the other extreme, though there are still survivals of old prejudices. In considering the economic functions of trade unions, it is most important to distinguish between their normal actions in normal times, and their actions in strikes and times of acute conflict.

3. Functions of Trade Unions. — Trade unions are voluntary associations of labour for mutual assistance, protection, and benefit. Their objects are (in the phraseology here used) to diminish the quantity of labour involved in work and to increase the real reward; they are designed to add to the power of labour in making bargains by the substitution of combination for competition.

It is clear from this wide definition that there are many ways in which the unions may seek to interfere with the conditions of employment; and conflicts arise, sometimes pushed to the extreme of a strike, that have nothing to do with money wages. The unions also in many cases perform the functions of benefit or insurance societies, and of bureaus for the organisation and employment of labour. Their object has been described in sympathetic language as to elevate the social position of the members (Webb). In the present work the attention must in the main be confined to the influence of the unions (in relation to associations of employers) in fixing money wages and earnings. From this point of view it will be necessary to consider not only their effects on particular wages, but also their effects on what may be called the general rate of wages. The object of trade unions, as regards money wages, is to raise them above the rate that they would attain under "natural" conditions and competition. The fundamental assumption is that combinations of labour can make better bargains than labourers in isolation.

Such a rise above the competition rate may be effected in one or other of three ways: at the expense of the consumer of the product; at the expense of other wages; at the expense of profits.

4. Wages and the Consumer. — A rise of wages at the expense of the consumer of the *particular* product implies that the particular class of labour considered can in effect obtain a monopoly price without checking too much the demand for the commodity. The conditions to make such a combination effective are: that other labour can be

excluded, and that machinery cannot take the place of labour; in brief, there must be an effective limitation of the supply of one of the requisites of production. Next, from the point of view of demand, there must be on the part of the consumer a non-elastic demand so that a rise in price will have little effect on the quantity demanded; there must also be an absence of acceptable substitutes. If the labour in question is necessary, but of small value in comparison with the total product, a considerable rise of wages might take place without any appreciable effect on the total price and the demand, and if the other factors of production are relatively weak in bargaining power, then also the rise of wages is so much the more easily made in the fortunate group.

Favourable conditions of this kind would be offered if in any locality there were a sudden and great demand for houses. In this case there is no effective substitute, and a considerable rise in price might have little immediate effect on the demand. Thus, if other labour could be excluded, the local house builders might force a rise at the expense of the consumer of the houses. Any particular branch of labour required that happened to have a very effective union (and the sympathy of the members of the trade throughout the country) might raise its particular wages still more in proportion to the other trades engaged in building. It is plain that such conditions as those indicated are not likely to occur generally, or to continue for any time. Suppose, then, that these favourable conditions are absent, and yet that, for the time being, a rise of wages is effected by a strong combination in some group of labour at the expense of the consumer of the product. If the

rate of wages is above the "natural" rate, that is having regard to the conditions of the employment, etc., labour will be attracted to that group, and the children available will be kept in that trade. Thus it will be difficult to regulate or control the supply of labour. If the rate of pay is kept up, the annual earnings must fall, unless there is an increase in the demand for the commodity.

But when we turn to demand, in general the rise in price will check the demand and will encourage the use of substitutes and economies, and thus, on the whole, the field for employment will be lessened.

Some of the indirect effects may be noticed if the article raised in price is widely consumed directly, and indirectly in other forms of production, *e.g.* coal.

The rise in price is equivalent to a tax on a necessary, and falls most severely on the poorest; it is equivalent also to a tax on the raw material of manufactures or the motive power, and the consequent rise in price again taxes the home consumer. It will tend also to check exports and indirectly to check the imports sent in return for the exports. Thus there is so far a tax both on the productive power and on the consuming power of the nation at large.

If, to carry the argument a stage further, a similar policy is attempted by all the important trades, and an attempt is made to raise all wages at the expense of the consumer in general, the effect is so far obviously suicidal because the labourers themselves constitute the great mass of consumers. Such a policy also, in view of the effects of unrestrained foreign competition, would probably lead to a demand for protection.

The conclusion then appears to be that, although wages

and earnings may in exceptional circumstances rise at the expense of the consumer through the action of a strong union, a general rise at the expense of the general consumer would lower real wages by a still greater amount.

5. Wages and Profits. — The next question is: Can wages be raised above the competition rate at the expense of profits?

As regards any particular trade, if the profits are struck at more than in other trades, capital will tend to leave that trade or will not be replaced. Accordingly, under the ordinary conditions of competition, a rise of wages at the expense of the particular profits concerned would lead to a lessened demand for labour; and if the rate of wages were kept up, still the annual earnings would fall. If, however, the trade that was attacked by the union had been obtaining exceptional or monopoly profits, a considerable rise of wages might be effected without lessening the demand for the labour in question.

When we consider the possibility of a rise in general wages at the expense of general profits, the case is in one important respect essentially different from that of a particular trade under competition. If all capital is struck at simultaneously, the owners cannot indemnify themselves by transferring the capital to other trades. And if capital is sent abroad, it will only earn interest (and not wages of management) unless the owner also emigrates. Accordingly, to some extent, it seems that general wages may be raised by strong unions at the expense of general profits. There can be little doubt that if the unions had been stronger in the beginning of the nineteenth century, such a rise might have been effected, and in all probability the

general rate of wages in the second half of that century has been raised through the unions. At the same time the fallacy of *post hoc ergo propter hoc* must be avoided. During the same period wages in agriculture have risen, and the wages of domestic servants have risen still more; and in these cases the direct action of trade unions has been *nil*, and even the indirect effect probably not very great; though no doubt if unions have raised other wages, there is a sympathetic rise in occupations not directly affected.

It is always difficult to separate the effect due to one particular cause from a complex result. The general growth of wealth, due to improved methods of production, would of itself tend to raise wages; and conversely, the restrictive action of the unions might to some extent retard the accumulation of capital, and thus so far check the natural rise in wages.

Again, under present conditions what may be termed the debatable surplus is relatively small. From the selling price of the product must be deducted all the necessary expenses, if the production is to continue, and amongst these are to be enumerated a sufficient amount to cover the depreciation and wear and tear of capital, and a necessary minimum of profits. By the latter term is now meant no more than such an amount of profits as will suffice to keep up the supply of capital. No doubt also amongst the necessary expenses must be reckoned wages sufficient to keep up the supply of labour; but the larger the amount already taken by labour as its living wage, so much the more is the debatable surplus contracted. Other considerations may be advanced to support this line of argument. Thus, as already shown,

profit is complex, and we may consider the possible effects of trade unions on each of the elements taken separately. Profit-interest is so closely associated with loan-interest that there is always an interaction between the two. It is clear that trade unions can have little or no power in reducing loan-interest, and thus their influence on profit-interest is also limited. Again, the present rate of *pure* interest is so low that if the whole of it were taken from productive capital it could not raise wages very much. The element of insurance against risk ought properly to be included in the expenses of production, just as the replacement of wear and tear. Wages of management seem to offer a better object for attack, but again they must be divided into two parts. A large part of the gross wages of management is only the "natural" payment for professional skill of a high character, and may be said to be earned out of the greater productiveness of industry as a whole under the guidance of the entrepreneur. If we take the wages of management in an ascending order, from the wages of foremen and the heads of departments up to the highest organising skill, the importance of this factor is readily seen. Any attempt to transfer this part of the wages of management to ordinary labour would probably result in a fall in wages through the check to efficiency. There remains the smaller part of wages of management that is of the nature of rent or quasi-rent. This is the part that is directly most open to attack, and as a rule a share in any good fortune that befalls the industry of a country can be taken by labour, beyond what would be obtained by the natural effects of competition, provided

the labour combinations are strong. Similarly as regards the effects of improvements, part of the benefit may be transferred to the consumer in a fall of price, but part may be retained by labour at the expense of quasi-rents. In this case, however, the indirect effects must also be taken into account. It is the hope of these exceptional rewards that gives such a stimulus to enterprise on the whole, and if it were possible for ordinary labour to appropriate every gain as it arises, there would soon be a dearth of these gains. It must always be remembered that competition of capital for labour tends to raise wages, and the object of trade unions is to raise wages above this so-called natural rate. The unions are not able to affect the demand for labour and for the varied products of labour, and the utmost they can do is to take advantage of favourable conditions.

The influence of the unions is best seen in preventing a fall in wages. If a fall is rendered really necessary by the conditions of trade, as in a period of general depression, the unions can only keep up rates of wages at the expense of greater losses in earnings. But, on the other hand, any economy in the wages bill gives so great a gain to profits that the tendency is for masters to reduce wages whenever occasion offers. At present the chief object of unions as regards money wages seems to be to make a relatively high minimum wage a necessary condition of production, just as certain sanitary conditions are made necessary. It is maintained by those who approve of this policy, that the other parts of the competitive system will be left unaffected, and that on the whole the efficiency of industry will be increased by insisting

on this reasonable minimum. And there is little doubt that a continual cheapening of labour might lead to degradation and inefficiency, whilst in a narrow sense it is to the interest of individual employers to try to cheapen labour; for to the individual the gains of promoting the general welfare of labour seem too far off compared with the present gains of a reduction in wages.

6. Evils of Conflicts of Labour and Capital. — In disputes between labour and capital, with trade unions on one side and associations of employers on the other, the ultimate appeal is to a strike or lockout. It is easy to show that the direct loss incurred during a strike by the loss of wages may take years to recover from, even if the strike is successful. The amount in dispute is often not more than five per cent; but suppose that it is as much as ten per cent, and the strike lasts only six weeks. The total loss of wages during this time will need a year to effect a compensation, if the strike is successful — and the rise is retained. If the percentage in dispute is less and the period of the strike is longer, so much longer will be the period requisite for compensation. Apart from the direct losses of the strike there are the evil effects on the families of the workers and the losses occasioned by forced sales and debts. On the side of the masters there is no actual physical distress, and there may be no immediate injury to most of the fixed capital; but there are great losses as a rule through the disorganisation of business connection and the openings given to foreign competition. The masters in some cases have every compensation in the rise in prices of accumulated stocks and in the maintenance of prices for a time, even

after the strike has ceased. But on the whole a strike or lockout involves much more than a loss of profits during the time.

In a general view, also, account must be taken of the increase of class animosity and jealousy, and of the feeling of insecurity as regards enterprise, which in the end will adversely affect the general productive power of the country.

Accordingly, everything that tends to substitute the methods of industrial peace for conflict, other things being the same, is a national gain.

7. The Harmonies of Labour and Capital. — In many cases the economic interests of labour and capital are only in apparent conflict, and the difficulty is for the stronger side to recognise the real harmony. There can be no doubt that many institutions, laws, and customs, apparently only designed in the interests of labour, have been indirectly of advantage to the employer. Improved conditions of work have increased the efficiency of labour. So also, on the whole, has the rise in money wages. The economy of high wages expresses a great truth, especially when we regard the effects from the national standpoint.

Even as regards the debatable surplus, methods of conciliation are to be preferred whenever possible. Among such methods may be noticed first of all sliding scales. The principle of the sliding scale is the recognition of the connection of wages and prices. The chief difficulty is that wages is not the only element in cost, and sometimes is not the most important. The price of the product may rise because the raw material is dearer, or the coal. Again, there are difficulties caused by the differences in qualities and in the methods of

production. Thus it has been said, that with a perfect sliding scale, a different scale would be required for every mine. The great advantage of this method is that it is automatic, if once the scale is agreed on, and the mode of ascertaining the movements in prices, and the intervals at which the readjustments are to be made, have been settled.

In theory, the methods of so-called industrial partnership, or profit-sharing, or "bonus" grants, seem most attractive. In effect, labour is supposed to create the extra profits or bonus that it receives by greater efficiency and economies. The chief difficulty is when with falling prices the bonus disappears and the workers think it is a case of mismanagement. Industrial partnerships of this kind do not imply, as a rule, any share in the management or any share in the losses (apart from the loss of the bonus).

A development of this system is found when an opportunity is given to the workers to acquire a certain amount of shares in the business (Carnegie). Here again the danger is in the risk of the loss of the capital in bad times.

Lastly, there is the method of coöperation, in which, in its full development, the workers provide both the capital and the business management. Coöperation has had an immense success in trade as distinguished from production in the narrow sense. But although recently there has been some increase of coöperative production, the aggregate amount in the industrial world is of little importance. The great difficulty seems to be in the management. There is a natural reluctance to give either sufficient powers or sufficient wages to the managers.

On the whole, then, it seems that the wage system will be retained and the difficulties will be best surmounted by boards of conciliation and arbitration adapted to the circumstances of particular industries. Boards composed equally of masters and men, with an independent chairman with a casting vote, or with some provision for reference to a neutral authority, seem to have worked well over long periods. The difficult question then arises, whether arbitration in some form should not be made compulsory, especially in the case of industries in which there are great national interests at stake (*e.g.* railways, shipping, coal, etc.). An adequate opinion on the relative merits, and the difficulties involved in these various methods, can only be formed after a careful inductive inquiry. General principles and ideas can only give guiding clues.[1]

[1] The theory of combination of labour and capital as connected with the theory of monopoly value is treated in *Principles*, Book III, Chap. VIII. On the subject of this chapter there is a vast literature. The *History of Trade Unions* and *Industrial Democracy*, by Mr. and Mrs. Webb, give the latest and most complete realistic treatment; Brentano, *Gilds and Trade Unions*, may be corrected by the *Gild Merchant* of Dr. Gross; *Industrial Peace*, by L. L. Price, may now rank as a standard work; Marshall, *Economics of Industry*, Book VI, Chap. XIII, gives an excellent account of trade unions; see also Hadley, *Economics*, Chaps. XI-XII; Gilman, *Profit-Sharing;* Nicholson, *Strikes* and *Social Problems;* Pierson, *Principles*, Part I, Chap. VI, § 2; Sidgwick, *Principles*, Book II, Chap. X; the older ideas are well stated in Holyoake, *History of Coöperation* and *Conflicts of Labour and Capital.*

CHAPTER X

ECONOMIC RENT

1. Different Meanings of the Term *Rent*. — The term *rent* is used in various senses. It is applied to the total revenue derived by the owners from lands, houses, mines, forests, fisheries, and various other forms of property. In former times the towns paid a rent to the king for their privileges and to the feudal superior for their markets. With this wide extension of the term, rent is sometimes equivalent to the interest on some forms of capital; sometimes it includes besides interest other elements of profits; rent may be in effect a payment by instalments for raw materials or minerals; it may be a tax imposed by authority, or the result of a monopoly created by circumstances.

In separating economic rent from these other usages it seems best to begin with the meaning assigned to it by Ricardo in dealing with the rent of agricultural land. This was the meaning for a long time so generally adopted that the pure theory of economic rent was known alternatively as the Ricardian theory.

This case is at any rate of importance in itself, and it has the advantage of bringing out with great clearness the fundamental conceptions and their mutual relations. When once these leading ideas are made clear, it is easy to extend the theory in whole or in part to similar cases; *e.g.* to houses, mines, fisheries, etc., and to the varied

forms of income to which Professor Marshall has assigned the name *quasi*-rent.

To begin with, the primary object is to unfold the meaning of the theory, and for this purpose all the non-essential features must be abstracted. Later on, in dealing with historical or practical problems, account can be taken as the abstract method demands of various disturbing causes.

In the abstract method, it may be recalled, we start with certain propositions that are obvious in themselves, or at any rate may be taken for granted. Such are in this case the law of diminishing return to land in its two forms (intensive and extensive): the equality of prices for the same produce in the same market, and the tendency to equality of profits (or better, the instability of exceptional rates).

It will be found that the theory assumes different forms; but the following may be taken as the definition of economic rent (in the case of agricultural land).

Economic rent is the differential profit that arises from differences in the cost of production, owing to differences in permanent natural conditions.

Ricardo used the expression *natural and indestructible powers of the soil*, and he did not bring out the abstract nature of the theory. He made clear, however, one of the fundamental assumptions that is often overlooked or misunderstood; namely, that the same amount of labour and capital, or productive power, is applied under different natural conditions, but not necessarily to the same amount of land. In brief, the object is to explain not the differences in rent *per acre*, but the differences in profits, although no doubt greater simplicity may be attained by the further

assumption that each acre of land requires the same amount of capital.

2. Economic Rent from Extensive Cultivation. — The theory may be first worked out with the law of diminishing return in its extensive form: we assume that there are various qualities of land, and that the better qualities are limited.

Take, for simplicity, a new country dependent on its own supplies and occupied by a body of settlers. At first we may suppose that there is an abundance of the best land and that it is practically free. In this case only the best land will be used, and the produce will sell so as to just cover (with current wages and profits) the expenses of production. It cannot sell for more as that would provoke competition, and there is plenty of good land available. So far, there is no differential profit and thus no economic rent.

As population increases the yield from the best land (the methods of cultivation remaining the same) will not meet the demand. The relative scarcity raises price, and at this higher price it pays to resort to inferior land. Now the same amount of capital yields different amounts of produce on the two qualities of land; but since all the produce must sell at the same price, a differential profit emerges from the better land. This constitutes economic rent and may be measured in produce or in money. (In theoretical problems both measures may be useful.) The land that yields no rent is called the land on the margin of cultivation, and the capital that yields no differential profit is the marginal capital.

As the population is supposed to increase still more, this

second quality may not suffice to meet the demand; in this case the margin is again extended to inferior land, and the former marginal land now yields a rent and the best land a higher rent. The process may continue indefinitely so long as population increases and there remains inferior land to be taken into cultivation. Under these suppositions there is always some land on the margin that pays no rent, and with every extension of the margin rent rises. The theory as so far developed involves three main results which it is best to make explicit.

(*a*) So long as the demand, say the number of people, remains the same and the methods of cultivation are unchanged, the price must remain high and the economic rent is permanent. In the case of other things in which the supply can be increased without resort to more difficult conditions, an extra profit, due to a rise in demand, can only be temporary.

(*b*) Rent depends on price and not price on rent. It is the rise in price that pushes out the margin.

(*c*) The price depends on the most expensive portion necessary to satisfy the demand — that is, on the cost of production on the land on the margin that pays no rent. Thus again we see that rent does not govern, but depends on price; and the price depends on the marginal cost.

3. Economic Rent from Situation. — It is easy to show that advantages of situation act in the same way as degrees of fertility. In order to isolate this element, suppose all the land is equally fertile, but at different distances from the market. At first, only the nearest land is used; with an increase of demand and rise of price, it will pay to go to more distant land; the rise

of price just compensates on the marginal land the extra cost of carriage of materials and products, and the nearer lands can pay rent.

4. Economic Rent from Intensive Cultivation. — Suppose now that all the land is of the same quality and equally distant from the market. If the land is as abundant as before, there is no rent; but if after all the land has been taken up, it is desired to raise more produce, in response to a rise in demand the law of diminishing return, in its intensive form, will come into play. More capital will be applied to the land, but there will be a diminishing return per unit. The idea now is, that if the last applications of capital just gives ordinary profit, the prior "doses" must give more. If, however, the last or marginal dose is to be applied year after year, the price must remain high. Therefore the differential profits on these prior doses must arise every year, and the economic rent is permanent so long as the conditions of demand and of production remain the same.

It is this form of economic rent that generally presents most difficulty. It is well to remember that the marginal, or last dose of capital, is not necessarily the last in time. It may be in the form of extra labour in cleaning the land which in time would be first expended. The separation of the "doses" and of the corresponding returns, though difficult in practice, has to be calculated in some way; that is, the farmer must decide on the intensity of the cultivation that will pay, and stop the applications of capital at the margin of profitable return. In theory, the separation is seen most clearly by means of diagrams (see end of this chapter).

5. Economic Rent from Scarcity. — Suppose now that all the land is equally fertile and well situated, and that the conditions of cultivation are such that the returns to successive doses of capital are equal; that is to say, the law of diminishing return is not supposed to operate. As before, if the land is abundant, there is no rent, but if the land is limited and scarce, with a rise in demand, economic rent will emerge. The produce will sell at such a price that it will give a differential profit over the ordinary applications of capital in other industries; this profit will be permanent so long as the conditions of demand and production remain the same; and it may be ascribed to permanent natural conditions. It thus comes under the definition adopted above of economic rent.

The chief point to notice is, that the rent in this case is not a monopoly rent; the land may be in the possession of different owners in competition with one another, and there may not be even tacit or customary combination. Scarcity alone is not enough to give monopoly; all things that have value are relatively scarce.

6. Combination of the Different Forms of Economic Rent. — For the sake of clearness in the exposition, the different forms of economic rent have been treated separately. We must next observe that in practice they are generally combined. The same rise in price, consequent on an increase of demand, will render it profitable to cultivate the old land more highly and also to resort to less fertile and more distant lands; and after a certain point it may happen that all the land in cultivation will yield a scarcity rent.

Although the treatment adopted has been abstract, it is to be noted that all the causes are real or true causes. A good practical illustration of a rise in rent is afforded by England in the early years of the nineteenth century. Recently in England we have had an example of a fall in agricultural rent. To account for this fall in rent, we have only to take the fall in the price of produce as given; it is in fact due to foreign competition. In response to the fall in price the margin has receded.

In the exposition of the theory the usual plan has been followed of supposing first an increase in population, and as a consequence an extension of the margin. The theory, however, is essentially the same if we suppose that in the first place improvements are made so that there is a greater produce at the same cost. To begin with, the produce will fall in price; but if the fall in price stimulates population, the price will again rise to its former level. Under these circumstances there will be first a fall and then a rise in rents.

The theory of the effects of improvements on rents leads to some difficult problems that can only be solved by the aid of diagrams or mathematics. The general principle applied is that improvements counteract the law of diminishing return, and since rent in most forms arises from the operation of this law, as the law is counteracted the rent falls. The improvements are of course supposed to be general; improvements on one portion of land only would increase its particular rent.

The general effects of economic progress on rent are treated in the fourth book in the plan here followed.

So far only the elements of the theory of value have

been assumed: no more indeed than may be taken for granted after the exposition already given of wages and profits. At a later stage some attention must be given to some of the relations of rent and value that are not so obvious (see Book III).

7. **Rent of Non-agricultural Land.** — Land, in its extended meaning in economics, is held to cover the income from natural resources in general. The gross rent of mines is partly payment by instalments for a stock of material and partly a differential payment for relative advantages in position or working. If it is assumed that there is a continuous gradation of mines of varying degrees of productiveness and accessibility, it is the marginal cost that determines the price, and any saving in cost in the more easily worked mines (including transport) is economic rent. It differs from agricultural rent in that it is not permanent: it is similar in that diminishing return may act both extensively and intensively; more distant and inferior mines may be worked, and in the best mine more costly methods of extraction may be adopted.

In sea fisheries there is no rent, because there is no appropriation. When appropriation is possible, as in the case of salmon, a rent arises. In this case, since the stock is renewed annually by natural means, the rent closely resembles that of agricultural land; and again we have extensive and intensive diminishing return.

In building land, we have the best example of the permanence of natural qualities, namely, extension and situation. In the case of cities with widely extended suburbs, there is continuity from the central positions that

pay enormous rents, to the land on the margin that pays no rent (*qua* building) or only the equivalent of agricultural rent. The case is exactly similar to that of agricultural rental with a difference only in the kind of produce: the kindly fruits of the earth are now amenity for dwelling-places and advantages in business. There is often

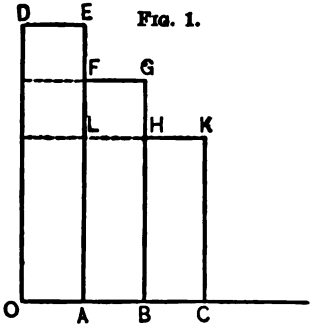


Fig. 1.

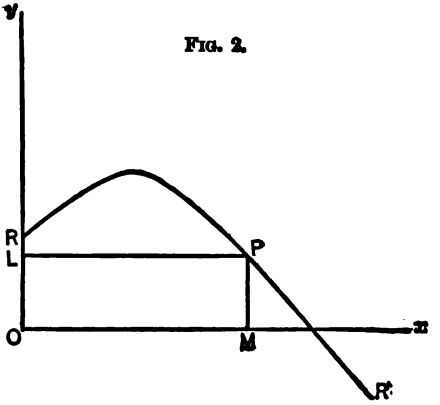


Fig. 2.

Let OA, AB, BC (Fig. 1) be three equal portions of land or "doses" of capital. Let OE, AG, BK be their respective corn product. Then if AB is the marginal portion, or "dose," Rent $= DF$; while, if BC is the marginal portion, Rent $= DL + FH$.

If, as in Fig. 2, we take the portions of land or "doses" of capital to be very small, then corresponding returns become lines, the ends of which form a curve. If the M^{th} be taken as the marginal dose, then Rent equals RPL.

present also the scarcity element which as before must be distinguished from monopoly. If commodities are sold at the same price in shops in different streets, the higher rent in some is to be ascribed to the economies possible with greater and more continuous custom. If the more fashionable neighbourhoods exact higher prices, they must be considered in part only as payment for the

thing, and in part as payment for entry to the locality: a kind of tacit or customary entrance fee. This part of the price is naturally transferred to the owner of the locale as economic rent.

8. Quasi-rent. — Quasi-rent is properly taken after the theory of value. It resembles true economic rent in that it depends on price, and is not a determinant of price. It differs in that it is not due to natural conditions, and is not permanent, but tends to disappear under the influence of competition.

It is sometimes useful to represent economic rent by rectangles as well as by the usual curves. The connection of rent with diminishing return is well shown in Marshall's *Principles* (4th ed.), pp. 232–235. The leading ideas are brought out in the figures given above.[1]

[1] For elementary exposition without mathematics, see Walker, *Land and its Rent;* in Marshall's *Principles* (see Index) the treatment is rather scattered; Hadley, *Economics*, Chap. IX; Nicholson, *Tenant's Gain not Landlord's Loss;* Pierson, *Principles*, Part I, Chap. II.

BOOK III

EXCHANGE

CHAPTER I

VALUE AND MARKETS

1. Exchange. — The third great department of political economy — namely, exchange — is closely related to the other two. With the progress of society production involves more and more division of labour, which is limited by the extent of the market. In distribution, also, status and custom give place to contract; and contract from the economic standpoint also involves the idea of exchange. At the same time, both production and distribution involve other ideas and topics, *e.g.* population, property, etc., which are only indirectly of importance in this third department. In exchange the fundamental idea is *value*, and the main problems are the relations of values. The first requisite is to make clear the conception of value.

2. Value. — The term *value*, as was pointed out by Adam Smith is used popularly in at least two senses. It may mean *value in use* or *value in exchange*. To say that a thing has value in use is to say that it has utility. As already shown, utility is the widest term in economics, and accordingly it is not suited for specialisation in the department of exchange. Utility is a complex conception (*e.g.* total and marginal utility), and the ideas which it involves may be made clear by reference to consumption and production without bringing in exchange. Utility

is indeed essential to exchange value, but exchange value is not essential to utility. Again, utility is subjective in the last resort, whilst exchange is objective. In the same market at the same time every one pays the same price for the same thing, but the utility to each purchaser may be different. Records of prices are actual definite facts like the readings of the barometer or the markings of geological strata, but there is no such objective record of utilities.

At the same time the very idea of exchange — its motive power — is the gain of utility; and in considering the real advantages of exchange and the real cost involved we are thrown back on the fundamental ideas of utility and disutility.

3. Value in Exchange. — Exchange value implies two things at least; value, in other words, is a relative term: the intrinsic value of one thing can only mean its utility.

The exchange value of a thing can be expressed theoretically, in terms of any other thing that is exchangeable.

In practice in modern societies the other thing taken for comparison is generally standard money. In this case value becomes price. The question then arises: Are we to say that exchange value is always to mean price? and that the distinction between value and price is to be abandoned?

The answer is that in some important problems it is necessary to contrast the prices with values measured in some other way.

The essential thing to remember is that value is a purely relative term; it expresses the rate of exchange of one thing compared with one or more other things.

Theoretically, we may express the value of any one thing in terms of *all other exchangeable things* taken together. This is Mill's idea. The value of a thing as distinct from its price, on this view, is its general purchasing power.

This conception of general purchasing power proves to be unworkable unless we introduce the idea of price; to find out the general purchasing power of a thing, we must usually compare its price with the general level of prices. Rogers compared the average prices of a large number of commodities in the period 1400–1540 with their prices in the period 1540–1581, and he found that everything except glass had risen in price; here it might be said that the value of glass, in the sense of its general purchasing power, had fallen.

The case, however, that is always of the greatest importance in this mode of estimating value, is the case of money itself. It is often of importance to measure changes in the purchasing power of money in reference to things in general. Thus the depreciation of inconvertible notes may be measured either in reference to gold or in reference to commodities.

Again, as will be shown in the theory of money, the *price* of gold is fixed by law; its *value* in terms of things is constantly changing. To find the changes in value in this sense, we take certain things as representative, and from the movements in their prices we estimate (by some method of index numbers) the general movement in prices. If prices measured in this way have risen, that means the value of gold has fallen; and if prices have fallen, the value of gold has risen.

From the mode adopted in measuring changes in the value of gold, it is clear that we are not entitled to argue that the change in value has been uniform throughout the whole range of commodities. Thus it might happen that although general prices as estimated by the index numbers had fallen, several of the things of importance in workmen's budgets (*e.g.* house rents), had risen; in this case it might happen that the purchasing power of money wages had actually fallen in spite of the rise in the value of gold.

It is sometimes convenient to express the value of particular things in reference to something else instead of money. Here attention may be called to the fallacious idea that so long prevailed that there was something discoverable that by nature was especially adapted to measure values as distinct from prices — a supposed *real measure* as contrasted with money, the *nominal measure*. Thus Adam Smith speaks of real and nominal price: by nominal price he means value in terms of money; by real price, value in terms of labour. The distinction is sometimes useful, but the notion that value in terms of labour is more real than value in terms of some other thing is quite false.

It is not a question of reality but of methods of comparison. Mill's idea that the proper correlative in the expression of value is "things in general," seems to imply that this is the one real meaning of value; and this may be said also of recent attempts to reduce value to utility.

The point to grasp is that for different purposes we may express the relation of value in different ways; we generally choose money, but not always; *e.g.* in the

theory of rent it is often useful to take corn as the measure, and sometimes in practice grain rents have been preferred to money rents.

4. Relative Prices must be adjusted to Relative Values. — It has already been implied that the general level of prices may change, and the causes of such movements will be examined in the theory of money. At this stage, however, the proposition may be laid down, that whatever changes take place in the *general* level, *relative prices must be adjusted to relative values.* A change in the level of general prices is the same thing as a change in the measure of values, and the mere change in the measure cannot in itself affect the relative value of the things. The relative values depend on real causes, *e.g.* the quantity of labour and capital required to produce them, etc.; and these causes are not affected by the mode of measurement.

At the same time it may be indicated that during the period of transition from one level to another there is often a temporary disturbance of relative prices, and thus of values. It may happen also that a change in general prices may itself be due to a disturbance of relative values, though the explanation involves one of the most difficult points in monetary theory. At present all that is intended is to make clear the meanings of, and the connections between, values and prices.

5. A General Rise of Values is Impossible. — If the term *general* is taken in the strict sense as applicable to *all* the things that are the subject of exchange, it is a truism that if some fall in value the remainder must rise in value relatively to the first set. If any one thing obtains more of all the rest, the value of all the things except that one

falls compared with that one; but the exclusion of that one makes the fall not general in the strict sense. If the one thing that rises in value is gold, that means a fall in general prices : gold obtains more of all other things, and they obtain less gold. Thus a general fall (or rise) in prices is quite possible, and such movements are constantly taking place, as is indicated by the changes in the index numbers of the *Economist* or Mr. Sauerbeck (*Statistical Journal*).

6. Other General Propositions on Value. — Other general propositions on value, of wide-reaching import, and closely connected, are that: commodities pay for commodities; that demand and supply are reciprocal; that all exchange is ultimately barter; and that money is the medium of exchange. An increase in the supply of commodities means indeed that those who make these things desire to obtain money; but then they usually desire to spend this money when obtained, either in consumable things or in so-called intermediate goods, and thus exchange becomes barter and the extension of supply involves an extension of demand. In foreign trade the form assumed by these propositions is that imports are paid for by exports, and that the balance of trade is adjusted by reciprocal demand.

It is no doubt true that there may be a disorganisation of the means of exchange, as in monetary and credit crises, and thus, relatively to the means of distribution by the agencies of trade, there may seem to be a general excess of supply or a deficiency of demand. In this sense overproduction may be very real; but not in the sense that more things of *all* kinds are produced than people in general desire to consume or are able to purchase. The disorgan-

isation of markets through overproduction of some things or through the scarcity of money (or its credit representatives that will be accepted) is of frequent occurrence in modern times ; but such disorganisation does not controvert the truth of these general propositions, but rather serves to illustrate the truth by contrast.

7. Markets. — The simplest case of barter consists of the exchange of two commodities by two individuals; and in order to illustrate the advantages of exchange in the gain of utility, this case may be useful. But in general, exchange implies that there are a number of buyers and a number of sellers, and that the things are not directly bartered, but in the first place the sellers sell *for* money and the buyers buy *with* money. The organisation by which exchanges of this kind are effected is called a market.

The history of the development of markets is one of the most important parts of the history of economic progress. At first there were definite limits of time and place, as in the market days of market towns, and in the great fairs that still survive. From the earliest times markets came to be held under conditions that insured *publicity* in the transactions, *freedom of trade*, and *competition;* in mediæval times regulations were in force to prevent sales being effected on the way to market, and special privileges were granted to traders at fairs and markets. A typical, highly organised market of modern times shows these characters more fully developed. The limits of space and time have been extended in the sense that the conditions of demand and supply all the world over, as also the prospective conditions, affect the dealings of any particular market; for the great staples of international trade the market-place is

the whole world; and, similarly, there is a continuous flow of goods, instead of varying supplies at intervals. Publicity has attained such a point that dealings in distant places are recorded at once by telegraph; and the restraints formerly imposed on speculation have practically disappeared, though occasionally attempts are made to bring them back (Germany); and dealings in "futures" are the chief characteristic of some modern markets. In spite, however, of the extension and development of markets, both time and space still impose their limitations. The demand alike for consumable commodities and for the raw materials and the appliances of manufacture is a demand for immediate use, and must be met at the time and place considered; and the prospective supply and demand only affect the present supply and demand indirectly.

At any rate, for the purposes of theory it is still best to assume that the market is held or made within certain fixed limits of time and space, and that market prices are the results of actual bargains at particular times and places, as contrasted with normal prices, which are the ideals that are the results or goals of tendencies.

Every one knows that market prices are determined by demand and supply; but these terms are by no means so clear as they are familiar. In the analysis that is requisite two cases must be distinguished: there may be perfect competition on both sides, or there may be various degrees of monopoly.

To begin with, we may follow the usual practice, and suppose that there is perfect competition, which implies that all the buyers and sellers in the market are equally

well informed as to the conditions affecting demand and supply.

It is found best for clearness to take separately the laws of demand and supply, and then to explain what is called the equation or equilibrium which determines the market price. In order that a thing may possess exchange value it must have utility, and there must be some difficulty in the attainment. Neither condition alone is sufficient.

Utility is of most importance in demand; difficulty of attainment in supply: but, as will appear in the analysis, demand and supply are correlative. Demand implies power to purchase, and supply implies desire to exchange; and thus demand involves an estimate of the difficulty of getting money, and supply an estimate of the utility of getting it.[1]

[1] This chapter is based on Book III, Chaps. I, II, III, and X, of the *Principles* (Vol. II), and is much abbreviated. Value is treated in all the text-books, and it seems unnecessary to give special references to the general theory. The peculiar doctrines of the Austrian school are well summarised in Smart's *Introduction to the Theory of Value;* the *Measurement of General Exchange Value* is the title of an able and elaborate monograph by Correa Moylan Walsh; for index numbers, see Bowley, *Elements of Statistics;* a brief account of the simplest method is given in *Money and Monetary Problems* (pp. 132–134).

CHAPTER II

OF DEMAND AND SUPPLY

1. **The Law of Demand.** — By demand is meant the quantity demanded at a certain price, it being assumed that the buyer can and will pay the price or that the demand is effectual.

It is clear that demand must mean more than desire to possess, because every one desires everything; and the less the means of payment or the chance of acquisition, so much greater may be the desire. The qualification "at a certain price" is essential, because, as a rule, for every price there is a different quantity demanded. This is expressed by saying that the quantity demanded is a function of the price.

The general law of demand states that as the price falls, other things remaining the same, the quantity demanded increases (or better, as Sidgwick says, is *extended*), and conversely, as the price rises the quantity demanded decreases (or better, is *contracted*).

The law of demand, as thus stated, is applicable to everything that bears a price, or is the subject of bargaining in terms of money. It applies, no doubt, to manufactures (the usual illustration), but it also applies to all the varied forms and usages of land labour and capital. If the price of land rises, other things being the same, the demand falls off; if wages fall, the demand for servants will so far increase; if the rate of discount

rises, the demand for advances is checked; and if on the stock exchange some security falls in price, it will so far extend the demand.

In theory we may suppose that there is a perfect continuity in prices and in quantities (as illustrated in the *demand curve*). Above a certain price there is none demanded, or the price is prohibitive; as the price falls, more and more will be demanded, but at last no more will be taken even at a nominal or zero price; and after this point is reached, the demand will become negative, or the seller must pay something to get rid of the thing.

The last phrase leads to the remark that the law of demand may be stated in a converse form, namely, that in any market under given conditions, to get rid of a larger supply prices must be lowered. So long as the conditions prevailing in the market are given, it makes no difference whether we begin with the prices or the quantities, since the law of demand simply expresses the relations between the two. In fact, if, instead of curves, we use demand schedules (Marshall), we set down on one side, or in one column, prices, and in the other the corresponding quantities, — and which is on the right hand and which on the left is of no consequence. The first statement, however, seems preferable, because it refers only to demand, whilst the second in form refers rather to supply.

The degree or the rapidity of the change in the quantity demanded in response to changes in price, varies in different cases. If for a small rise or fall in price there is a great change in the quantity demanded, the demand is said to be elastic; and conversely, if a

considerable change in price has little effect on the quantity demanded, the demand is non-elastic (Marshall). Variations in elasticity are shown in the shapes of the demand curves, but the idea may be made clear by concrete examples. A tax on bread, which in this illustration may be supposed to raise the price, will check the demand to a small extent only, even if the tax is heavy, — that is, the demand is non-elastic; on the other hand it is said that any addition to the tobacco tax would so check the demand that it would yield no more revenue — the demand is elastic. The elasticity of demand is of great importance in connection with the elasticity of revenue. With regard to the effect of small variations in price, as represented in the continuity of curves, the supposition is not so unreal as might appear at first sight. In estimating the total demand in any market we must add together the demands of all the different persons for all sorts of purposes. Thus in the case of sugar, there is not only the demand for direct consumption, but the demand also for cakes, jam, and beer. Similarly, as regards the factors of production of various kinds we must take the aggregate demands including indirect, derived, and joint demands. These terms may be explained by an example. The demand for new houses for occupation is a direct demand: there is a joint demand for the various forms of labour and raw material, etc., used in the building trade; and for any one of these factors — *e.g.* the labour of house-painters — there is a derived demand (Marshall).

2. Changes in Demand — Rise and Fall in Demand. — Any change in the conditions affecting the demand for

a thing will cause a change in the nature of the demand (illustrated by a change in the curve). Thus, if there is a rise in the relative utility assigned to a thing, a higher price will be given for a certain quantity. This *rise in demand* may be expected to operate at every range of prices, although it is unlikely that the rise will be exactly uniform throughout. (In the language of curves the new curve will be above the old curve, but not raised to the same extent exactly throughout.)

By a fall in demand is meant, that at given prices people will take less; or lower prices will be offered for the same quantities. (The new demand curve would fall below the old curve.)

Changes in the law of demand for a thing may arise from various causes. Such are the extension or contraction in the use of substitutes; an increase or decrease in the wealth or means of people; changes in the utility assigned to the thing or, it may be, in the estimates of present and future uses.

With regard to the influence of changes in utility it is the *marginal* utility that must be considered. As already explained, the utility of the first portions of necessaries may be considered practically infinite; but after a certain point is reached more utility may be obtained by expending the next sum of money on some luxury. The total utility of the luxury is less, but at the point reached the degree of utility is greater.

In the same way the total utility of present consumption may be greater than that expected from the creation of some form of capital, but after a point it may be more acceptable to save than to spend.

The value of the distinction between total and marginal utility extends far beyond the possibility of exact measurement.

3. The Law of Supply. — The law of supply may be stated, *mutatis mutandis*, as the exact analogue of the law of demand. Supply means the quantity offered for sale at a price. The quantity offered, other things remaining the same, will vary with the price. The supply, like the demand, is a function of the price. The general law of supply is that: As the price rises, other things remaining the same, the quantity offered at that price will increase, and as the price falls the quantity offered at that price will diminish. The law is thus exactly symmetrical with the law of demand. Similarly also, it is applied to anything that bears a price or is saleable. Other things being the same, with higher wages more labour will be offered, with higher interest more loanable capital, and generally with higher prices more land, more works of art, more stock exchange securities, and in short, more of everything vendible will be thrown on the market. And conversely of falling prices; some of the former sellers will draw back and withhold their supply. These examples show that the law of supply extends far beyond the range of manufactured articles. If a saleable thing is of such a kind that if time is allowed it can be increased, then no doubt the conditions of production and the period required for adding to the effective supply will indirectly affect the price at which supply will be forthcoming. But it is best logically to take this case separately. (See next chapter.)

It is easy to show that we may also apply the same

ideas of elasticity, rise and fall, etc., to supply as were applied in the case of demand. Thus with some things a slight rise in price will bring out large stocks, in other things it will have little effect; and the supply may be said to be elastic and non-elastic respectively. Again, if through the whole range of the schedule of prices for a thing more is offered than before, that constitutes a *rise in supply* (and conversely of a *fall in supply*), if we use the terminology already adopted in the case of demand. People may be more willing to sell than before, owing to temporary pressure for money, as in a crisis, or there may be the possibility of substitutes from other sources not formerly available.

4. The Equation between Demand and Supply — The Temporary Equilibrium Price. — We may now combine the two laws of demand and supply so as to show the way in which demand and supply determine market price. As before, this general statement of the operation of demand and supply will apply to anything for which there is a market (that is to say, under the conditions of competition — the case of monopoly being deferred).

In any market at any time (or in a unit of time) the price will be so adjusted, through the competition of buyers and sellers, that the quantity demanded will be equal to the quantity offered at that price. This is the equation price (Mill), or temporary equilibrium price (Marshall).

It is necessary to bring out in some way, by reference to competition or to the higgling of the market, the fact of the process of adjustment. Otherwise we are landed in the barren verbalism that in any market the

quantity bought is always equal to the quantity sold (Cairnes).

It may be advisable to make explicit other conditions that are generally taken for granted in the determination of market prices. Mill, for example, writes of markets: "in which the *axiom* prevails that for the same article of the same quality there cannot be two prices." This *assumption* is only true in so far as the conditions requisite to perfect competition prevail, *e.g.* equality of knowledge on the part of all the buyers and sellers concerned.

The possible buyers are not supposed to go into the market absolutely determined to buy so much — *coûte qui coûte* — whatever the price; but their demand will be adjusted according to the state of prices; and similarly of the supply and the sellers. Thus there will be all degrees (within limits) in the intensity of the desire to buy and to sell respectively. An eager buyer, to be safe, may open the market by offering more than would have been necessary if he had waited for the effects of competition, and conversely an eager seller may accept less than he might have obtained if he had waited. The higgling of the market consists in finding out by tentative offers what are the real conditions affecting the demand and the supply on the whole, and what price will leave the least unsatisfied demand or supply (in the limit make them just equal). Thus on the stock exchange the prices of speculative stocks in periods of excitement will vary from moment to moment; in fact every sale so far alters the conditions of the market, to say nothing of the intervention of external causes in the shape of rumours. And even in non-speculative securities there are movements in

the prices, although we may calculate the price of the day on the average.

In times of panic and disorganisation there are widely different prices at the same time in the same market. Similarly, if we take the case of undeveloped markets, such as the bazaars of the East, there is a set of independent bargains at different prices.

5. The Immediate Effects of Changes in Demand and Supply. — So far we have supposed that both demand and supply are functions of the price, and that, given the conditions or the schedules or curves, we can determine the price at which sales will take place under the influence of competition.

We must now consider the immediate effects of *changes* in demand or supply or both (of the nature already described) upon the price.

This consideration leads to a second form of the law of demand and supply. If the demand rises, supply remaining the same, the price rises; and conversely, if demand falls, the price falls. Similarly, we may suppose that the change begins with the supply, the demand remaining the same; or there may be changes, in the same or in different directions, in both demand and supply.

The various possible cases and the effects on price are best illustrated by means of curves: but they are all deducible from the real meaning of these changes.

A rise in demand means that people will take more at the old price; and accordingly if the old price were to remain undisturbed, there would be unsatisfied demand, and then the competition of buyers raises the price. Similarly, a rise in supply means that people will sell more at the

old price, and therefore if that price remained, there would be unsatisfied supply; and by the competition of sellers the price would fall.

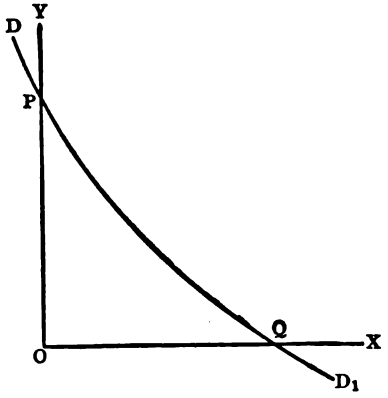
6. Ulterior Effects of Changes in Demand and Supply. — We may now consider the ulterior effects. Take first the case of a rise in price due to a rise in demand. If the supply cannot be increased, then the rise of price is permanent, as in the case of building land in growing cities.

If the supply can be increased, the ultimate effect depends on the conditions of production. If the conditions are such that the law of diminishing return comes into play, then also the rise of price is permanent so long as the conditions remain the same. If, on the other hand, the increased supply brings into play the economies of large production (or the law of increasing return), though the price rises in the first instance, it will ultimately fall to a lower level. The reason simply is that if the old price were maintained there would be exceptional profit.

If in the conflict of opposing forces there is a balance of increasing and diminishing return, the price after the temporary rise will return to the former level. This is the case of constant return.

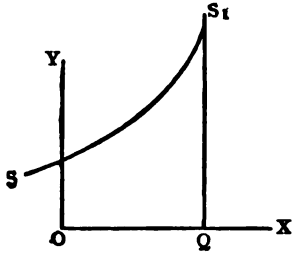
Similar reasoning may be applied in the case of a fall in price due to a fall in demand. One example may suffice. Suppose that the commodity is produced according to increasing return. Then as the production is contracted the cost rises. Thus in the end the price may rise to a higher level than before. This process may go on, the rise in price checking the demand, and thus again contracting the supply, until the commodity ceases to be produced. In this, as in the other cases taken, there are various coun-

teracting causes. Thus the so-called law of increasing return does not act in such a way that all the economies are lost if the production is contracted. It may happen simply that the weaker producers are driven from the market.[1]



At the price OP, none is demanded; at zero price Q, no more than OQ will be taken (satiety); between these limits with every fall in price the quantity demanded increases. To induce people to take more than OQ, a bounty must be given or the price becomes negative.

If the curve is steep, it is non-elastic, if flat, elastic. In the limit if the curve becomes parallel to OY, that means perfect non-elasticity, — whatever the price, the same quantity is demanded; if the curve becomes parallel to OX, there is perfect elasticity, — the smallest change in price extends or contracts the demand indefinitely.



At price OS, none is offered; as price rises, more is offered; if after S_1 the curve becomes parallel to OY, whatever the change in price no more is offered, — scarcity prices.

[1] See *Principles*, Vol. II, Book III, Chaps. IV and VI. The *law of demand* is treated by Marshall in *Principles*, Book III, and the *equilibrium of demand and supply* in Book V. Book IV treats of the agents of production. The treatment differs from that here adopted in that the symmetry of demand and supply is not insisted on.

Fig. 1

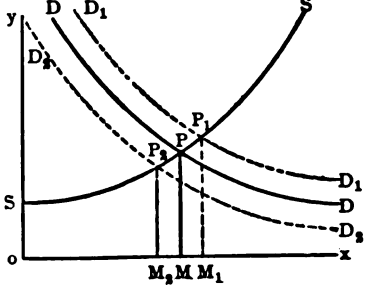


Fig. 2

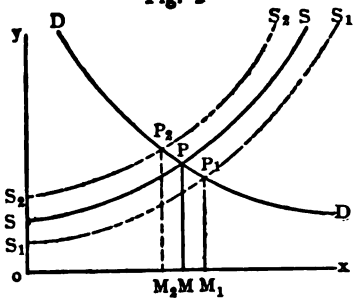


Fig. 3

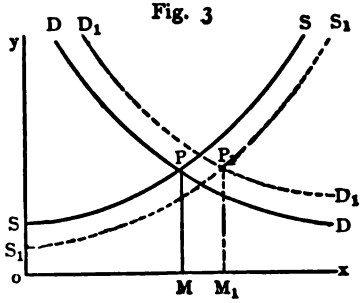


Fig. 4

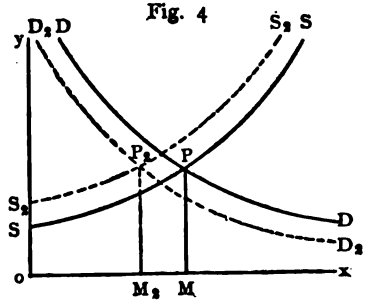


Fig. 5

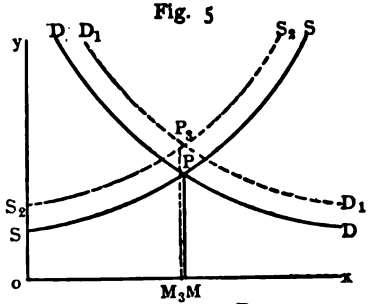
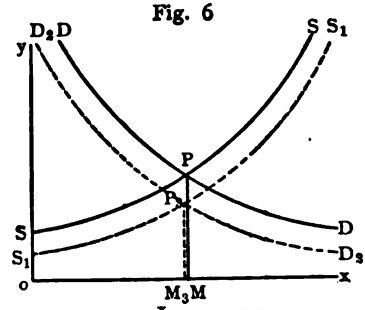


Fig. 6



CHANGES IN DEMAND AND SUPPLY AND THEIR IMMEDIATE EFFECTS ON PRICE.

I. Demand only changing: (*a*) Rising — effect $P_1 M_1 > P M$ (Fig. 1).
(*b*) Falling — " $P_2 M_2 < P M$

II. Supply only changing: (*a*) Rising — effect $P_1 M_1 < P M$ (Fig. 2).
(*b*) Falling — " $P_2 M_2 > P M$

III. Both Demand and Supply changing, and in the *same* direction:
(*a*) Rising (Fig. 3); (*b*) Falling (Fig. 4). Whether new price will be greater or less than the old price is indeterminate.

IV. Both Demand and Supply changing, but in *opposite* directions:
(*a*) Demand rising and Supply falling — effect $P_3 M_3 > P M$ (Fig. 5); (*b*) Demand falling and Supply rising — effect $P_3 M_3 < P M$ (Fig. 6).
In all these cases the rise or fall is supposed to be uniform throughout.

CHAPTER III

NORMAL VALUE AND COST OF PRODUCTION

1. Meaning of Normal Value. — Market prices are the actual prices recorded in actual market quotations, and in theory they are the prices determined under the conditions of demand and supply that represent the essential conditions of these markets. These market prices are subject to incessant fluctuations, but [in certain cases] there is a central or natural price to which the prices of [some] commodities are continually gravitating (Adam Smith). The conception of natural or normal price is generally associated with commodities that are manufactured or produced in the narrow sense of the term, and in general also it is said that the natural or normal price depends on cost of production. It is often further supposed, as by Mill, that on an average of years sufficient to enable the oscillations on one side of the central line to be compensated by those on the other, the market value agrees with the natural value; that is to say, that in the "long run" natural cost of production and average come to the same thing. Later analysis, however, has shown that the term *normal*, which has displaced the question-begging term *natural* must be carefully distinguished both from cost of production and from average values. The word *norma* is literally the square used by carpenters to get their work in proper proportion: it gives the ideal to which their

efforts are directed. By analogy the term has been extended to mean the law or pattern to which any variations tend to conform or be restored. Normal may thus be taken to be the adjective that corresponds to economic law (Marshall). In this sense it is obviously much wider than cost of production. Thus we can speak of normal rates of wages and profits in which the idea of cost of labour or capital is out of place. Again we may say that *normal* monopoly value is that which gives the maximum net return, and in general this is above the value that would result from cost of production under competition.

This last example also illustrates very clearly the difference between normal and average, for the actual monopoly profit can never exceed the normal and is sure sometimes to fall below it, unless the monopolist is supposed to be omniscient. In the first seventy years of the nineteenth century the normal ratio of gold to silver was $15\frac{1}{2}$ to 1, but it was only remotely influenced by cost of production. Adam Smith himself observed in dealing with ordinary cost, the market price is likely to remain longer above than below this cost; and whether this opinion is accepted or not, it shows that on this view the average price for a long time might exceed the natural price.

But although *normal* value is wider than *cost* value and different from average, *one* important form of normal value is that which is determined by cost of production, and *in general* the *cost of production value* is closely connected with the *average*. We may now examine the relations of cost of production to market values.

2. Real Cost and Money Cost. — By *real* cost in econom-

ics is meant the sum of the efforts and sacrifices that are necessary to produce a thing. So far as this conception is capable of analysis, it has been dealt with in the examination of the meaning of production and again of real wages.

In some of the problems of value it may be necessary again to go back to this ultimate cost (as in considering the real advantages of foreign trade and distribution of the advantages between the countries concerned). In general, however, in this department we do not go beyond the *money* wages and profits that are necessary to call forth these efforts on the part of labour and capital.

From this point of view the ultimate elements of cost of production are the money wages and profits of all the various persons concerned in the production; that is, we consider the money values required to compensate the disutilities of real cost.

Strictly speaking again, in modern industrial societies, this would involve an endless series of prices. There is the cost of buildings, of transport, etc., and even the cost of the government to be taken account of; and at first sight this endless series of money costs would seem to be as unworkable as the corresponding disutilities of real cost.

But we can adopt the common device of neglecting forces below a certain magnitude, and we may confine the attention to the more general causes; and we must try to discover general formulæ that are applicable to many particular cases.

It must never be forgotten that value is a relative term; the problems of value are problems of ratios, and in normal values we are dealing with normal ratios.

It follows, then, that in dealing with cost as the deter-

minant of values we cannot simply take the money cost of one thing by itself: we have to deal with the *relations* of the cost of different things.

As in most parts of the theory of value it is necessary to adopt the abstract or deductive method. The most ardent advocate of the realistic treatment of economics could make nothing of the records of millions of particular prices unless he had some guiding ideas for their classification. Even the calculation of averages will not itself reveal causes, and some idea of causes must be formed before the subjects of statistical investigation can be selected. A glance over the volumes of Thorold Rogers or the later prices of Tooke and Newmarch will at once show how hopeless it is to appeal directly to what are supposed to be facts.

According to the deductive or abstract method, we begin with the operation of certain forces under hypothetical conditions. It must be premised, however, that although the *conditions* are hypothetical, the *causes* are real and always of fundamental importance.

3. The Analysis of Cost of Production. — Suppose first that all the things considered are produced by *labour* of the same kind and efficiency, and that the contribution of capital is so small that it may be neglected. Under these conditions, as was pointed out by Ricardo, the values of the things would vary simply and directly with the *amount or quantity of labour* that they required. If all the labour is uniform and paid at the same rate, the general *rate* of wages makes no difference. It is usual to illustrate by reference to "economic savages," but it is easy to give examples in modern societies in which the chief

determinant in relative values is the quantity of unskilled labour required to make the things, *e.g.* in the relative costs of parts of canals, railways, etc.

Again, if we regard capital itself as the product of labour, the relative values of the buildings, machines, etc., required to assist labour, will depend partly, at any rate, on the *amount* of labour involved in their construction, though in this case it is complicated by the variations in the kinds of labour and degree of skill.

In order to take adequate account of differences in the *kinds* of labour, it is necessary to bring in the money measures or the differential *rates* of wages. We refer back to the causes of differences of wages in different employments. We may take it that under given industrial conditions there are certain normal ratios of wages for different kinds of work. These are the normal ratios about which the market rates of wages oscillate.

In estimating *now* the relative values of commodities produced by labour (the influence of capital being still negligible), we compare the labour bills reckoned in terms of money. If all the labour were uniform, and paid at the same rates under the supposition that only the cost of the labour need be considered, a rise or fall in the rate of money wages would have no effect in disturbing relative values. Any change in *relative* rates, however, would have an effect; in the respective labour bills a change in the rate of wages in one case operates as effectively as a change in the quantity of labour.

The introduction of money wages as a determinant of cost and thus of value, demands a word of explanation in the light of some recent but one-sided developments

of the theory of value. If (in the absence of capital and profits) the price obtained for the product is distributed in wages paid to the producers, it may seem a verbal truism to say that the cost depends on the wages. But the point is that we are not dealing with the *particular* cost of a *particular* thing, but with the relative normal values of various things. There are certain real causes that determine relative wages, *e.g.* a plumber gets more than his boy, a carpenter gets more than an agricultural labourer, a man gets more than a woman. These differences in rates may be illustrated at any time or over relatively long periods. If, then, one thing requires, for the most part, highly skilled and trustworthy labourers, and another requires only unskilled labourers, without characters, the value of the former will be so much higher. The amount of labour (the number of men, the hours of work, etc.) is still the dominating factor, but it is no longer a case of every one counting for one, and no one for more than one.

If the market price of anything happens to rise, then for the time being the labour required, if strong enough in bargaining power, may obtain more than the normal rate current for that kind of labour, but such a rise in price would not, in general, suffice to permanently raise the relative wages of that particular form of labour. And if in certain cases such were the effect, it must be ascribed to the conditions affecting the supply of that labour at least as much as to the movement in price. After this explanation, which applies later on *mutatis mutandis* to relative profits, the results of the further analysis may be indicated very briefly.

Suppose next that all the things are made directly by *capital* without the intervention of labour directly. We may suppose that we have everlasting machines that only require the eye of the master to keep going. The relative values of the things so manufactured will be determined, in the first place, by the relative *amounts* of *capital* required. This is exactly analogous to the quantity of labour of the first case ; and if we bring in relative profits, we have the analogy to the second case. If the machines are indestructible, the only element in cost is the profits, for the machine remains. Under these conditions a rise or fall in *general* profits would not affect relative values ; but any change in relative profits would disturb the relations just as effectively as a change in the quantities of capital required.

We may now approach nearer to actual conditions and suppose that things are made partly by labour directly and partly by auxiliary capital. In this case a rise or fall in general wages, compared with general profits, will disturb relative values according to the *proportions* in which labour and capital enter into the cost of the different things.

Further complications are introduced when we take account of the different degrees of durability of the fixed capital and the amounts of labour required in constructing the different forms. The principle applied throughout is that anything that affects values equally does not disturb their relations, because a general rise or fall of values is impossible.

The raw material of some manufactures is of more importance than the labour bill (as in paper made from esparto or rags). The value of the raw material will again

depend on the relative conditions of production. There may be elements of monopoly or scarcity; or diminishing return may come into play, in which case the normal value of the material depends on the marginal cost.

These closer approximations to actual conditions, though in one way they complicate the general argument, in some respects they make it more clear. When we take account not only of what is called the prime cost, but also of the share borne by a thing of the supplementary cost, it becomes still more clear that the normal prices of finished goods do not determine the rates of wages, but rather the converse. Railways and steamers are essential to the cotton manufacture and to all the other manufactures of the country. A rise in the price of one of these manufactures might for the time raise the wages of the labour directly concerned, but it could hardly affect the wages of the thousands engaged in transport.

In conclusion it may be repeated that the normal values must be expressed in relation to something besides money. Cost must be separated into its component factors; and for each of these factors there is a demand that is relatively large compared to the demand derived from the particular product.

The principle that tends to make the market values gravitate to the normal is in modern industry on a large scale the so-called tendency of profits to equality. The expression is apt to be misleading, and as explained in the chapter on Profits, it is better to speak of the instability of exceptional rates.

The "law of substitution" (Marshall) expresses the continuous striving for new economies in production; these new

economies, so long as the old price is maintained, give exceptional rates of remuneration which are a species of *quasi*-rent. But *quasi*-rents, like true economic rents, depend on prices and not prices on *quasi*-rents. (See next chapter.)

Case of Joint Products.—If we suppose that two or more things can only be produced together, or that it would be just as expensive to produce any one as this one with the others, we have the case of joint cost: *e.g.* wool and mutton, etc. In this case the normal price of the two together will tend to conform to the aggregate cost of production, and the relative prices of the joint products will depend on demand and supply. Suppose that there is a rise in the demand for wool, so far that raises its price, but the demand for mutton may be supposed to remain undisturbed. There will be a rise in the value of the wool and mutton combined, or there will be exceptional profits in sheep farming. Accordingly more sheep will be reared until the total yield gives an ordinary return. With the increase of supply the price of wool will fall to some extent, but the price of the mutton will fall still more.

It should be observed that the producers of joint products can in general exercise some influence on the relative proportion of supply of the two factors, or at any rate can influence the quality. Thus with a rise in wool sheep would be bred with the idea of improving the stock as regards wool, and conversely of mutton. The general principles applicable to the aggregate joint cost will vary with the conditions of production, *e.g.* increasing or diminishing return. The case of joint products is of much wider application than is generally supposed at first sight,

e.g. nearly every manufacture has some product which was formerly considered as waste, but, owing to improvements in production or changes in demand, acquires value.[1]

Note on Expenses of Production.

In the article on Value by the present author in the *Encyclopædia Britannica* (9th ed.), a formula is given which illustrates the complexity of the expenses of production of ordinary commodities. In this formula account is taken of the amount of fixed capital required, the rate of wear and tear, the rate of profit, the amount of labour, the price in wages of the labour, and the time of production. No special reference is made to raw material or to the elements of supplementary cost or to differences in the rates of wages of the different employees. And yet even as so simplified the formula seems complex. To compare the relative expenses of two commodities and thus their cost values, we must take a similar formula for the second commodity.

Let E_1 represent the expense of production (as indicated) of commodity A. Q_1 is the value of the fixed capital, r_1 the rate of wear and tear per annum, P_1 is the rate of profit on the whole capital, Q_2 the number of labourers, w_2 the rate of wages, and t_1 the time. Then for commodity A we have

$$E_1 = \left[Q_1\left(\frac{P_1}{100} + \frac{1}{r}\right) + Q_2 \cdot w_2\left(1 + \frac{P_1}{100}\right)\right] t_1,$$

and for commodity B,

$$E_2 = \left[Q_3\left(\frac{P_3}{100} + \frac{1}{r_3}\right) + Q_4 \cdot w_4\left(1 + \frac{P_3}{100}\right)\right] t_3.$$

Changes are constantly taking place in all the elements taken, and others have been omitted. It thus appears that under modern conditions normal values are liable to frequent changes, if by normal we mean cost value.

[1] *Principles*, Book III, Chaps. V and VI; Mill, *Principles*, Book III, Chaps. III and IV; Marshall, *Principles*, Book V.

CHAPTER IV

RENT AND VALUE — MONOPOLY VALUE

1. Economic Rent as a Factor in Price. — It has been shown in the pure theory of rent that under the conditions laid down rent depends on price and not price on rent. The marginal cost determines the price and neither the marginal land nor the marginal dose of capital pays rent.

Certain exceptions, however, may be noticed to this rule when the conditions are changed.

Suppose that land can be used for other purposes and accordingly the land available for agriculture is diminished, *e.g.* if large quantities of land are afforested. Other things being the same, the marginal cost of the agricultural produce will rise. And the reason of this rise is that the distribution of land for different purposes is determined by the rent which it will yield.

Again, if we take the case of any new product the experimenters must pay the economic rent of the land that they require, and this rent will be an element in the cost. This assumes of course that for this product marginal land that pays no rent is not available, or is not of good enough quality. Indirectly also, as before, the price of the agricultural produce would be affected. The principle applied is that land is limited and the better qualities are still more limited. Accordingly, once it is

fully taken up, any appropriation for other purposes must diminish the supply for agricultural produce; this will raise the price and it will be profitable to resort to more intensive cultivation. Thus the exaction of rent for other purposes raises the price of agricultural produce.

In the intensive form of the theory of rent it is assumed that the application of capital stops at the last dose that yields ordinary profits. If the application were to be carried farther and the total capital employed were still to obtain ordinary profits, the deficiency on the last dose could only be made up out of rent. Thus there is a constant struggle between farmers and landowners as regards the advantage of certain improvements. If the farmer is to retain his profit, any loss that occurs, if the capital expenditure is pushed too far, must fall on rent. It is analogous to a tax levied on rent. At the same time the increase of produce due to the improvements will so far tend to lower the price, which again will lower rent. It is to the economic interest of the landowner to prevent this double fall in rent by limiting the intensity of the cultivation. This limitation, however, so far raises the price.

The necessity for limitation in order to maintain rent is still more clearly seen in the case of labour applied to small holdings. If crofters and squatters are allowed to apply as much labour as they choose to land, the rent will disappear. The increase of supply of produce, however, will *so far* tend to lower the price; though it is probable in this case that the inferior methods of cultivation adopted will more than neutralise this influence. The case of peasant properties is similar. If a value were placed on the

labour, the economic rent in many cases would be absorbed. Thus the displacement of peasant properties by large estates that are worked to pay a maximum rent would tend to reduce the amount produced and so far raise its price. On the other hand the recession of the margin would diminish the marginal cost so far as natural conditions are concerned.

Similar reasoning may be applied in the case of building land. Every landowner is supposed to let the land so as to give the highest rent; and it may pay best to keep the land vacant for a long time, rather than let it at a low rent for buildings which it would be expensive to remove when the land might be let on better terms for other purposes. So far this holding up of land gives the remainder a scarcity value, which indirectly raises the cost of houses to the occupiers. Whether this reservation of land is so much against the public interest as at first sight appears is another matter. (See *Principles*, Book V, Chap. XI.)

If the owners of land make a tacit or open combination the case reduces to monopoly value. So far as there is no combination, however, there is no monopoly.

2. ***Quasi*-rent.** — *Quasi*-rent is the term used by Professor Marshall to describe the "net incomes derived from appliances of production already made by man" which in some respects resembles true economic rent. "When we are considering periods of time too short to enable the supply of such appliances to respond to a change in the demand for them, the stock of them has to be regarded as *temporarily* fixed. For the time they hold nearly the same relations to the price of the things

which they take part in producing as is held by land or any other free gift of nature of which the stock is *permanently* fixed, and whose net income is a true rent." The term *appliance of production* is taken in a wide sense and is extended by analogy to business ability and manual skill.

Suppose that there is a rise in demand for any commodity and therefore for the time being a rise in price. The appliances of production cannot be immediately increased, and therefore those already in existence will earn exceptional rates of remuneration. Such exceptional rates may fairly be called *quasi*-rents. If the rise of price continues in time, the appliances will be increased, and *quasi*-rents considered as exceptional profits or wages will tend to disappear. In the same way if one firm makes an improvement, the differential profit may be called a *quasi*-rent, which will tend to disappear as the improvement is generally adopted. So far the conception is simple. A difficulty, however, is sometimes felt when we come to the case of a fall in demand and in price. Under these conditions the worst appliances will no longer be worked or there will be a recession of the margin. Some of the appliances will just yield the actual expenses of working them, but no surplus. But the excess of the price got by the goods made by the better appliances over their wear and tear, and the actual expenses of working them will be the net income which these appliances yield during the short period of depression. In this case the *quasi*-rent derived from the appliances (that is, the net income reckoned in the way described) will be less than the normal profit on the original investment. (Marshall,

Economics of Industry, 3rd edition, Appendix D, and *Principles*, Book V, Chap. IX.)

The conception *quasi*-rent must be taken with Professor Marshall's conception of normal value. Over a period long enough for the factors of production to conform to their cost of production, the price of the product depends on the costs of the factors, and it is to these long periods that the term *normal* is applied. If the period taken is too short for the supply of the factors to be readjusted to any change in the demand, the price of the product determines the income of the factors.

3. **Monopoly Value.** — The principles of monopoly value are of special interest at the present time owing to the extension of trusts, and the application of combinations to labour and capital. The general principles of monopoly can be explained without the aid of mathematics, and in this place only so much will be attempted.

We may begin with the simplest case of a seller's monopoly. Suppose (with Cournot) that an individual possesses a natural well that supplies some unique mineral water which practically involves no cost in the distribution. The owner must find out the law of demand. A very high price may be prohibitive, and at a very low price customers may be turned away, or in any case the return may be much smaller than if a medium price were adopted. The owner must try to discover what price will give him the maximum return. Whether this will be relatively high or low depends on the nature of the demand. It may happen that either a low price or a high price would give practically equal results. It is clear that a low price would be to the advantage of

the public, and thus so far there is a case for governmental control.

So far it has been assumed that the monopolist charges the same price (high or low) to all his customers. It is, however, easy to show that, theoretically, it would be to the advantage of the owner of the source to charge different prices to different consumers according to the supposed intensity of their desires, or simply according to their ostensible wealth and the supposed marginal utility of their money.

If in theory we assume perfect monopoly, it may be said that, just as perfect competition naturally leads to equality of prices, so monopoly leads to inequality. It is possible theoretically that it might be equally to the advantage of the monopolist and of the public that different prices should be charged to different classes. In general, however, discriminations of this kind, in the case of monopolies, have given rise to such abuses that they have been prevented. This suggests a second ground for the governmental regulation of monopolies. Thus, in principle, railways and cabs are not allowed to charge differential rates. In the modern "trusts" a favourite device is to charge lower prices abroad, especially if the home market is protected by a tariff.

In general the monopolist must take into account, not only the conditions of demand, but those of supply. Here different cases must be distinguished. If the expenses of production are independent of the quantity produced, they merely give a limiting or minimum price. The aggregate revenue must give at least this much, but the actual price fixed will, as before, depend on demand.

In most cases, however, the aggregate cost will vary with the amount produced. Even if the product is subject to the law of increasing return, and the supply can be increased at a diminishing cost, still this larger supply can only be sold at a lower price per unit, whilst the total cost is, of course, increased. In a case of this kind the calculation of the price that will give the greatest net revenue is a matter of great difficulty. It may be said, however, that in general the simplicity and the lessened risk of high prices prove most attractive to the monopolist. Thus it was only under the stimulus of governmental control that the railways discovered that the low third-class fares would give them the best return.

A case of great theoretical interest is that of a change in the conditions of cost, as by the imposition of a tax. Suppose that the monopolist has discovered the price that will give him a maximum net revenue, and that suddenly a tax is imposed. The question is, can he indemnify himself wholly or partially by raising his price. If the cost is independent of the quantity, and the tax is in the nature of a license to sell, also independent of the quantity, he can gain nothing by changing his price. If the tax is heavy enough, it may stop his production altogether, but he cannot transfer it to the consumer. In any case he has to pay the aggregate cost, and if he could gain after the tax by raising his price, he could have gained before the tax was imposed — but by hypothesis he has already fixed the best price.

If, however, the cost varies with the quantity, and the tax is so much per unit, then by diminishing his supply he so far diminishes his cost, and at the same time he can

sell the smaller supply at a higher price per unit. His revenue must, in any case, be reduced, but he may suffer less by raising his price and diminishing his sales. To take a simple illustration: Suppose the tax imposed is just equal to his original price per unit. If he still sells at the old price, he gets only enough to pay the tax, and he loses all the expenses of production. But if he raises the price, say, by the amount of the tax, he will, indeed, sell so much less; but on every unit sold he will gain the same net return as he would have done before on that amount.

4. Competition and Monopoly Prices Compared. — Under certain conditions monopoly prices may be more steady and uniform than competition prices. Under competition the stronger sellers may strive to undersell the weaker, and drive them from the market with the view of afterward establishing a practical monopoly. Thus there may be oscillations between low and high prices. Again, it is not necessary that monopoly prices should be higher than competition prices. The amalgamation of a number of small concerns may lead to great economies, so that the monopoly price, though fixed above the monopoly cost, may be still below the old competition price. This is the great argument used in defence of trusts.

Again, competition sometimes leads sellers to agree to a fixed price, without restrictions as to quantity. Competition in this form may be very keen and yet the consumer gains nothing, as in the case of retail trade with customary prices at a high level. Here competition may keep prices higher than would be to the advantage of a great monopolist.

In certain undertakings the public interest is best promoted by granting a monopoly to a company at any rate for a term of years. Suppose the undertaking is such as to require a large capital, and to involve a great experimental risk, whilst if successful it will at once provoke competition; a monopoly in such a case would be no more than the recognition of a species of copyright or patent.

5. Conditions Requisite to a Seller's Monopoly. — The monopolist to succeed must be able to regulate both the supply and the price. If the price only is regulated, the excess of supply may eventually destroy the monopoly. It is not sufficient to control the new supplies only; *e.g.* if old material can be used, as in the case of copper, or if the supply accumulates, as in the case of inconvertible notes, the monopoly price cannot be maintained. The case of the Bank of England during the restriction of cash payments is a good illustration. The notes were issued at par value, and the issues were supposed to be adjusted to the demands of trade, and yet in the end depreciation set in, or, in other words, the monopoly price could not be maintained. The new issues were regulated, but the notes already in circulation were beyond control.

Similarly, the monopolist must be able to prevent the use of substitutes. One of the great objections to the grant of patents is that similar discoveries must be suppressed to protect the patent rights.

Finally, the monopolist must be able to adjust quickly and easily both price and supply to any change in demand. If with a fall in demand he tries to maintain the old price, he will no longer obtain the maximum profit possible under

the circumstances, and he may even incur a loss. If he lowers the price but does not check sufficiently the supply, in the end his monopoly must break down.

It follows that monopoly is not likely to succeed in things for which the demand is variable and the supply not capable of ready adjustment.

In modern times monopolies are in general based not on government grants, but on voluntary combinations of individuals. Such combinations are difficult to maintain. If the price is fixed above the natural competition rate, there is the danger of external competition, especially if the commodity enters into foreign trade; and there is also the danger of internal competition, since any one producer may, by various devices, really lower his price without ostensibly infringing the regulations. The law will not enforce contracts in restraint of trade, and such voluntary combinations must depend on *esprit de corps*, etc.

6. Buyer's Monopoly. — In a buyer's monopoly the whole effective demand is on the part of one individual or a group acting in concert. Accordingly, to effect sales the sellers must submit to the buyer's terms; and such a buyer's monopoly may keep prices below the natural competition rate for a considerable time. Thus there may be an effective combination of employers as regards the demand for some kind of labour. The labourer cannot readily take to other occupations or hold out for a better bargain, and thus may be forced to accept the employer's terms. The only effective remedy seems to be to meet combination by combination.

An effective combination of tenants may keep rents below the competition rates, in which case part of the

true economic rent is transferred to the tenant. Such a result is really obtained when there is a low level of customary rents. When anything is naturally scarce or is the subject of a natural or artificial monopoly, the price may be lowered by an effective buyer's monopoly.

If a commodity is produced by labour and capital under the ordinary conditions of competition, a buyer's monopoly can only be successful for a short time, as the labour and capital will be withdrawn, or at any rate not replaced. In the same way the buyer's monopoly will fail if the commodity attacked can be transferred to other uses or other places.[1]

[1] *Principles*, Vol. II, Chaps. VII–IX. For historical examples of monopolies, see *Principles*, Vol. III, Book V, Chap. II. The effects of combinations of labour and capital on wages and profits are discussed in *Principles*, Vol. II, Book III, Chap. VIII; for the relations of rent and value, see Marshall, *Principles*, Vol. I, Book V, Chap. VIII–X; and for the theory of monopolies, *Ibid.*, Chap. XIII; Hobson, *Evolution of Modern Capitalism*.

CHAPTER V

FUNCTIONS AND SYSTEMS OF MONEY

1. What is Money? — The difficulty involved in the definition of money is best seen by considering the very different things that have performed, and still perform, monetary functions of primary importance. Materials of all kinds have been used. The gold sovereign displaced the silver pound, which was originally a pound weight of silver, just as the pound of silver displaced the older standard of value, namely, the man slave. Similarly, the ox was probably the origin of the shilling. Besides gold and silver, all the common metals and a great variety of other things have been used as material money, *e.g.* corn, oil, dried fish, tobacco, etc. In the course of monetary evolution coins took the place of ingots of merchandise; bank-notes were issued to represent coins and were convertible into coins on demand; convertible notes suggested inconvertible notes that represent nothing but hopes of deferred payment; banks created by their credit the bank money that is circulated by means of cheques; and the cheque is itself a development of the bill of exchange which is still of the first importance in the settlement of international transactions.

It is practically impossible to give a satisfactory definition of money that will cover all these varieties of things that do the recognised work of money. It seems then

best to adopt (though with a wider significance) the phrase of the late Professor Walker and to say: Money is that money does. We may then proceed to consider what money does or the principal monetary functions.

2. The Primary Functions of Money. — It is hardly necessary to illustrate the difficulties of barter. To avoid these difficulties something must be found, which having regard to the stage of development of the society, will be universally accepted. This is the essential characteristic of money considered as a *medium of exchange*. At first the thing must be such that it is highly prized on its own account, *e.g.* oxen, slaves, or the precious metals; but in the course of time the monetary function becomes of such importance in itself that things may perform the functions of a medium of exchange although they have no value for other than monetary purposes, *e.g.* bank-notes.

The importance of money as a medium of exchange is best seen in connection with the development of division of labour. The substitution of a money economy for a "natural" economy, or the commutation of payments in produce or in services into payments in money, marks the course of progress in every nation.

We pass now to the *second* primary function of money.

It is plainly impossible to exchange all sorts of things against any one thing, unless there is also some accepted *standard measure of values*. The function of money as a *standard of value* is of coördinate importance with its function as a medium of exchange, and the two functions are intimately connected. It is not necessary, however, that the actual medium should itself be the standard; it is sufficient if it is related as multiple or sub-multiple, or in

any definite relation that is capable of exact interpretation. Thus at present in the United Kingdom the sovereign is the standard unit of value; and all values are measured in parts and numbers of sovereigns. The actual payments, however, are made only to a small extent in gold coins; the actual medium of exchange consists of bronze, silver, and paper; and of banking transactions only a small fraction are effected by means of gold or coin of any kind.

The unit of value need not be a coin. The pound of silver was at first only coined into silver pennies, and for centuries even the shilling was only a money of account. It is worth noting that in the mediæval period money valuations were often adopted for the purpose of keeping accounts before the corresponding payments were effected by means of money: *e.g.* the villein services were measured in terms of money before they were actually commuted into money payments.

The difference between the measure and the medium may be illustrated by reference to produce, — say grain rents. Here the stipulated rent means so much grain, but the rent may be actually paid in money. In this case *grain* is the *measure* of value, and *money* is the *medium* of exchange.

The standard measure ought to be such that it will measure values not merely in a particular market at a certain moment, but it should also serve as a *standard for deferred payments.*

This function of money in the course of progress has become of so great importance that it is often described as a *third* primary function.

Experience shows that this requisite of money is diffi-

cult to fulfil. In one way it is simple enough to provide for certainty in the interpretation of contracts. It is sufficient to state that the unit of value is a certain weight of a certain substance of a certain quality, as we have in the legal definition of the sovereign or pound sterling. But the real meaning of monetary contracts involves the idea not of *weight* but of *value*. So long as inconvertible notes remain undepreciated, they serve the purposes of money equally well with gold. Even when depreciated, they would also serve equally well to measure values and to exchange commodities *at the same time and place*, but if from place to place or time to time their value changes, they vitiate so far the real meaning of monetary contracts. The evils of uncertainty of value in the money in terms of which contracts are expressed is also well illustrated in the debasement or depreciation of a metallic currency. (See the famous description by Macaulay of the disordered state of trade and especially of wages in the period preceding the recoinage of silver in 1696.)

Stability of value over long periods, or at least over periods for which monetary contracts are usual, is then one of the requisites of a good monetary standard.

It is, however, easy to show that perfect stability of value is unattainable except under the assumption that everything, including the prices of commodities and services, is fixed and stationary. Whatever substance is chosen as the material basis of the standard, under the conditions that at present prevail, it must be liable to fluctuations in value.

But at the same time some things have greater comparative stability if we take as the test of stability of

value their general purchasing power, which for monetary purposes seems the proper test.

Values depend on demand and supply, and causes of fluctuations in value may arise on either side.

Thus on the side of supply, corn and other forms of produce consumed within the year are not so stable as the metals which are relatively durable. Gold in particular is not only durable, but so precious that it is always taken care of. Thus the stock of gold in the hands of man is always very large compared with the annual supply. And so far its value is likely to be more stable than that of wheat.

Again, consider the influence of demand. Some things are liable to disturbances in demand through changes in fashion, the discovery of substitutes, etc.; but the precious metals, and especially gold, are always valued for their own uses as commodities, to say nothing of the monetary value that they have acquired by long usage. The importance of this last factor in demand is shown very forcibly by the recent depreciation of silver, which is due largely to a falling off in the demand for that metal for monetary purposes.

The value of gold is no doubt subject to fluctuations, but it is doubtful if on the whole they are so great as to call for the adoption of another standard on that account. Recently, however, the so-called appreciation of gold led many economists and statesmen to advocate the adoption of the double or joint standard of gold and silver. (See below, Chap. IX.)

To provide against the evil of fluctuations in value, what is termed the tabular standard has been proposed.

This is in effect an application of the theory of index

numbers, or it may be considered as a development of grain or produce rents. According to this plan certain representative commodities are chosen and their average prices for a certain period are calculated. If this original level is represented by 100, then according to the rise or fall in the average of these representative prices at any time this original index number of 100 is modified by the necessary percentage. Suppose that prices measured in this way had risen so that £106 would now purchase only what was formerly purchased by £100, then it is said, the purchasing power or the value of gold has fallen in that proportion, and that in equity the creditor for a gold loan ought to receive £6 more per cent on the repayment of the principal, and similarly of all contracts in terms of money; the debtor is supposed to agree to pay not so much *gold* simply, but gold of so much *purchasing power* as measured by this tabular standard. The objection to this method is that it is unworkable in practice. Even in the case of produce rents it was found preferable on both sides to take the speculative risk of a change in the value of gold.

Sometimes another function of money is explicitly stated, namely that of a *store* of value. This, however, seems to be derivative from money as a medium of exchange and as a standard for deferred payments. The early form of storing money for this purpose was simply hoarding; in modern times the chief store of *material* money is in the form of banker's reserves, which support a far greater amount of representative money. The function of money for the *transfer* of values is also derivative, and is now largely performed by credit.

3. The Qualities of Good Metallic Money. — It is easy to show by reference on the one side to the functions of money, and on the other to the qualities of the various metals, that silver and gold are preëminently suitable for money. The money material ought to be prized on its own account, and it should possess in a high degree the qualities of portability, durability, homogeneity of parts, divisibility, and cognisibility (so that its purity is easily tested). The latter quality is of special importance in the case of coins. A coin is defined by Jevons as an ingot, of which the weight and fineness are certified by the integrity of the designs impressed upon the surface of the metal. It is important that coins should show not only the original fineness and weight, but the absence of any subsequent alteration.

In former times false coinage was very general. At first, as usual, a remedy was sought for in the severity of the punishment; but here, as elsewhere, it was found that prevention was a more efficient remedy than retribution. Accordingly, in the course of progress we find more and more elaborate devices adopted so as to make imitation difficult. When the coins were hammered, the impression was feeble and the size irregular, and clipping and sweating were encouraged; the elaborate machinery of the modern mint cannot be readily made or worked in secret.

The design on the coins is not only of interest as a historical record and as indicating the extent of the king's peace, but it prevents counterfeiting and the fraudulent removal of the metal. The design should also be so contrived as to reduce the natural wear and tear to a mini-

mum. Under present conditions, when a large quantity of silver is current in different countries as full legal tender, although far below half its nominal or metallic value, the necessity of preventing fraudulent imitation is of great importance.

Coins have been made of all degrees of weight, and the only rule that can be laid down is the rule of convenience. When the silver penny was the only coin, it was too valuable for some payments, and too bulky for others; to remedy the first evil, leather tokens were issued; and to avoid the second, gold coins of foreign make were used.

4. Systems of Metallic Money. — The simplest and the most ancient system of metallic money is currency by weight. The French *livre* and the Italian *lira*, like the English and Scottish pounds, refer originally to the pound weight of silver. In this system the currency is practically a form of merchandise. Such a system, when found at present, is a sign of backwardness in a nation (China). It may also be resorted to in the case of a depreciation of the actual coinage, when the depreciation is recognised, and is not counteracted by restriction of the quantity. (See below, Chap. VII.) In international payments the exchanges are based upon the weights of the coins (the fine metal), and remittances are often made in bars.

In the system of *parallel* standards, two or more metals are coined, but no attempt is made to regulate by law their relative values. This method is so inconvenient as to be impracticable. When it is actually found, it is in general the result of a breakdown of a system of bimetallism, in which the legal ratio is no longer recognised.

Of this there are several examples in English monetary history which had important consequences.

In the *single legal tender* system only one metal is used (generally silver), as in the old English system. As already noticed, silver alone is inconvenient.

The inconveniences of the single legal tender are remedied by the *composite legal tender* system. The present English system is an example of this plan. One metal (gold) is full legal tender to any extent, whilst silver and bronze are token money of limited legal tender.

Jevons, from whom these significant terms are derived, also uses the term *multiple legal tender* system. On this plan two or more metals are full legal tender at ratios fixed by law. The most important case is bimetallism. (See below, Chap. IX.) To these may be added the *suspended* coinage system, which has resulted from the breakdown of bimetallism in recent times. In France and other countries silver is still full legal tender, but to keep up its value it is no longer coined for this purpose. In India, also, the coinage of silver has been suspended, as an indirect consequence of the breakdown of bimetallism, which dislocated the foreign exchanges and embarrassed the Indian government.[1]

[1] This chapter is abbreviated from *Principles*, Book III, Chaps. XI and XII; see also Nicholson, *Money and Monetary Problems* and *Bankers' Money;* Jevons, *Money;* Walker, *Money.*

CHAPTER VI

THE QUANTITY THEORY OF MONEY

1. A Hypothetical Market. — The quantity theory of money is, perhaps, the best example of the abstract deductive method. We begin with certain hypothetical conditions, and gradually introduce more and more disturbing forces, until we arrive at the complex relations of the present commercial world. The object of the theory is to explain the causes that determine the exchange value of money, or the general level of prices, according to the standard considered.

It is to be observed that, although, as in dealing with relative values, we begin with a very abstract statement of conditions, from the outset we are dealing with *real causes*. The point is that for the time being we abstract or take away other causes that are introduced at subsequent stages.

Suppose then that a market is set up under the following conditions: No exchanges are to be made without money passing from hand to hand at every transaction, thus excluding credit and barter. The money is to be considered as of no utility except for immediate exchanges; that is, there is no hoarding or reservation of the money. This condition implies that all the money is to be put into circulation, and is made explicit by saying that every

piece of money is to be used at least once in the interchange of the commodities in the market. It is also assumed that all the commodities must be exchanged for money, that all are on sale, and sold for the best price obtainable. Under these simple and fixed conditions, the value of the money will vary inversely with its quantity: in other words, the level of prices will depend on the quantity of money on the one side, and on the commodities to be exchanged on the other. Thus, if the money were increased tenfold (the commodities and the exchanges remaining the same), prices would rise tenfold; and similarly of a diminution of the money and a fall in prices.

Although the rise and fall in general prices is only *exactly proportioned* to the increase and decrease of quantity under these or similar hypothetical conditions, the quantity of the money is always a factor of the first importance. Thus the great rise in prices that took place in the sixteenth century is explained by the great discoveries of silver. Similarly, the fall in the value of gold after 1850 was ascribed to the gold discoveries in Australia and California. The best illustration, as will be shown later (see Chap. VII) is found in the depreciation of inconvertible notes through excessive issues.

It must be observed, however, even at this early stage of the exposition of the theory, that the quantity alone is not sufficient to explain the changes in the value of gold as is shown by the slight effect of the far greater discoveries of recent times. Even inconvertible notes, it will be shown, may be depreciated without excessive issues, and with excessive issues may escape depreciation.

We must then look for other causes, besides the quantity, which affect the value of money.

2. Influences modifying that of Quantity. — Suppose, now, that in effecting a given amount of transactions each piece of money in this same hypothetical market is used a number of times instead of once only. It is easy to see that this must have the same effect on the level of prices as if the quantity of money were increased in like proportion. The increase in the number of times the money is used is described as an increase in the *rapidity of circulation*. The phrase is open to objection (Mill), but it answers well enough if the idea is made clear; and this is, perhaps, best accomplished by a simple example. Suppose, then, that at first there are ten things, and one hundred pieces of money, and let the things be of equal value in the eye of the only possessor of the money. He will then give ten pieces for each thing; and each piece of money is used once only in effecting these ten exchanges. If, however, the man of money only desired one thing, and gave all the money for that thing, and the receiver passed it on in the same way in one lump to his neighbour in the market, and so on through the whole set of things and merchants, each thing would be sold for one hundred pieces instead of ten; and the essential point of difference is that each piece of money is used ten times instead of once.

This influence also may be illustrated, though not so sharply, by reference to actual commerce. Thus, if money circulates rapidly, a less quantity will suffice to keep up a certain level of prices. Again, with improvements in the means of communication and of transport,

money circulates more rapidly, or, to adopt Mill's phrase, the *efficiency of the money* is increased, and so far prices rise. Other modifying influences are more obvious in their effects. In all cases, however, it is best to compare these effects to those of a corresponding increase or diminution in the quantity of the money.

An increase in the *volume of the trade* is equivalent to a decrease in the quantity of money or so far prices fall. Thus, after the great discoveries of silver in the sixteenth century the rise in prices was partly checked by the increase in the volume of trade.

Suppose now that some of the exchanges of commodities are effected without the intervention of money, as by direct *barter*. This is equivalent in its effect to an increase in the quantity of money. A certain amount of money is set free to exchange the other things.

Next let us take account of the fact that the money material (say, gold) has itself great *utility apart from its monetary functions;* which, to begin with, is one of the requisites of a good medium of exchange. In this case the use of the gold for these other purposes will so far diminish the supply available for money, and thus prices will be so much lower. At present the use of gold in the arts, and for ornament, plate, etc., is very great, and it has always been so. Large quantities have been exported to the East and there hoarded; and in the West a large mass of gold is hoarded by the great military nations of Europe in their war chests. Similarly, a great part of the reserves of gold held in the European national banks has practically no monetary influence: to all intents and purposes it is hoarded.

The use of gold for industrial purposes illustrates very clearly the distinction between the *price of gold* and its *value*. The price is fixed by law. All that this means in reality is that a certain amount of gold can always be made into a certain number of sovereigns. Thus, at present, the English mint will make out of an ounce of standard gold (*i.e.* fine gold with a fixed proportion of alloy) three sovereigns, and the fraction of a sovereign that corresponds to seventeen shillings and tenpence halfpenny is left over: in brief, the mint price of gold is £3 17*s.* 10½*d.* But the purchasing power of this gold is subject to constant variations. Suppose, then, that owing to very great abundance of gold or any other cause prices rise very much, then the money incomes of people will also rise; and if the price of gold were to remain the same, every one would be willing to spend more on gold ornaments. Thus the gold would, to this extent, be withdrawn from circulation, and so far prices would again fall.

3. Cost of Production of Gold in Relation to its Value. — The quantity of gold can only be increased at any time under certain conditions at an increasing cost. Thus gold considered as a metal would appear to have its value determined by the marginal cost, as in the case of other commodities produced according to diminishing return. If, then, we also take for granted that an equal weight of gold in the form of coins must be of just the same value as the same weight of gold bullion (which is obvious if there is no charge for mintage and no restriction on coinage) then the value of gold money seems to be determined by the marginal cost of the production of gold bullion.

This reasoning is, however, fallacious. The value of gold, as so often insisted on, must mean its value compared with other things, and for general purposes we must take its general purchasing power; that is, the value of gold varies with the level of general prices. It is obvious, even at the present stage of the argument, that the level of prices must depend on a number of influences besides the marginal cost of gold. Such are, for example, the volume of trade and the rapidity of circulation: an increase in trade might more than neutralise an increase of gold due to a fall in the marginal cost, and an increase in the rapidity of circulation might raise prices or lower the value of gold in spite of a falling off in the annual supply, and an increase in the marginal cost. As will appear later, the influence of *credit* on prices in modern conditions is of the greatest importance; and it is clear that if money were compelled to pass from hand to hand (as at first assumed) in every transaction, to keep up the present level of prices the sovereign must be reduced to the size of a grain of sand.

But leaving for the present the influence of credit and representative money, the fallacy of the argument under review appears from another consideration. The annual supply is only a small part of the total supply, and of this annual supply only a small part is produced at the marginal cost. Thus at any time, or, say, over a period of ten years, the marginal cost can have but a small effect on the quantity of gold money. In any case, however, the value of gold, as of all other things, must depend on *demand* as much as on supply, and the demand for gold is governed

by the work which it has to do in effecting monetary transactions.

The truth then appears to be that at any time the value of gold (or the range of prices) is one of the factors which determine how far the margin of gold-mining will be pushed. If, owing to a general rise in prices, the price of labour and of machinery and of all the requisites of gold production also rise, then so far the margin will recede: the gold extracted at the old margin will no longer suffice to make coins enough to pay for the labour, etc., required. This recession of the margin will, in its turn, so far lessen the quantity of the annual supply of gold and thus affect also the amount available for money. In this way the cost of production of gold at any time or over any short period has an effect, though relatively slight, on the value of gold (or the general level of prices measured in gold).

It is, however, worth pointing out that if we consider very long periods, the cumulative effects of small causes may be very great. Gold was produced in prehistoric times, and the actual supply of gold at the present time is the result of the expenditure of labour and capital in the past. It is, then, no doubt true to say that had it not been for the difficulty in production, especially in the past, the quantity of gold would now be so much greater and the level of prices so much higher. There is one case in which cost of production is of special interest; namely, in considering the relative values of gold and silver. It is no doubt true that the recent depreciation of silver relatively to gold is due much more to changes in demand than in supply. But when we take into account very long periods so as to consider the cost of producing the aggregate in the hands

of man, then one reason why silver has always been so much less valuable than gold is that it has always been produced at less cost. We have no records of the actual cost of either metal, and the evidence is rather of a geological character; but it is in geology that the effects of cumulative causes are best seen.[1]

[1] For fuller statement of the quantity theory on the same lines, see *Money and Monetary Problems*; and for the older view (especially as regards the influence of cost), Mill, *Principles*, Book III, Chap. VIII and IX.

CHAPTER VII

GRESHAM'S LAW — TOKEN COINS — INCONVERTIBLE NOTES

1. Gresham's Law. — The economic tendency now usually described as Gresham's law in its popular form asserts that bad money drives good money from circulation, and conversely good money will not displace bad money. A preferable mode of statement which calls attention to the real meaning is: There is an alternative use for good money (or its material) for melting or export, and if it is worth more for other uses, it will not be paid away as coin.

Suppose that a large part of the actual coinage of a country has fallen below the legal weight, as was the case with the English silver before the great recoinage of 1696. Suppose, also, that the light money, or a good deal of it, still passes by *tale*, and that people have not yet reverted to currency by weight. Under these conditions the best coins will be chosen for export or use in the arts, because their metallic value is greater, whilst as money (by *tale*) they will only have the value of the worst coins that are accepted. Thus in the course of time the better coins will disappear, or in other words the aggregate coinage will get worse and worse. The operation of Gresham's law in this case depends entirely on the fact that the coin has two values. If all the coin were weighed and passed at the weight value, the good money would have an extra value as coin, just as it has as bullion.

If, under the conditions at first laid down, the government were to issue a mass of new full-weight coins without effectively withdrawing the old coins from circulation, these good coins would disappear, as the law states.

Like all other economic tendencies, this law is liable to be counteracted. Just recently, in England, for example, a large part of the gold coinage was below the legal weight, but the good coins, as they were issued, remained in circulation. The light coins were accepted as readily as the Bank of England notes payable on demand in full-weight coins, or as the full-value coins themselves. The question arises: How is it that for monetary purposes bad coins can remain on the same level with good coins, or that good coins cannot be sold for more bad coins?

The first answer is that by gradual and habitual use people have been accustomed to the inferior coins, and that the law which enjoins people to refuse coins below the proper weight is not observed, and probably in most cases not known. It suffices for most people to know that they in turn can pass on the coins. If, however, there were any difficulty in getting rid of the light coins, the depreciation would be recognised; the good coins would have a greater value for certain purposes, and would be withdrawn from circulation. Such a selective process had begun in England before the recent restoration of the gold coinage. The Bank of England only accepts gold by weight, and this bank is the bankers' bank; that is to say, it holds the ultimate real reserve of the other banks, and all superfluous gold is returned to the Bank of England. Thus the ordinary banks, in their own interest, would return the

light gold to circulation, and send the better coins to the Bank of England.

Apart from habit, however, there is a much more effective force that keeps up the value of the light coins. This is the principle of limitation. With a certain level of prices, and a certain amount of monetary transactions to be effected, a certain quantity of money is necessary. Thus, however small the metallic value of the coins, if they are limited, they may keep up their nominal value. It is this principle of limitation that explains most of the cases in which coins are kept in circulation, although far below the *metallic* value of other coins that pass at the same *nominal* value. The silver coins, for example, in France and other countries have not shared in the depreciation of the metal-silver; their value has been kept up only by the suspension of the coinage.

Experience shows that if the mints are open for both metals, a very slight difference will suffice to make the worse (or overvalued) coin drive the better (or undervalued) coin from circulation. (See next chapter.)

2. Token Coins. — The principles examined in the last section explain the regulations that have been found necessary to keep the token coins of a country on a proper footing. Token coins are coins the metallic value of which is avowedly and designedly below the nominal value, *e.g* the silver and bronze in England.

It follows at once, from the definition, that it is necessary to *limit* the right of coinage. If, under existing conditions, any one could take silver to the mint and have it coined into shillings, etc., there would be a profit of about 175 per cent on every transaction, at the present price of

silver (24*d.*). In the seventeenth century, in England, private tokens were allowed to be issued to any extent, and there were naturally excessive issues. From 1648 to 1672 there were over twenty thousand different kinds of tokens. Somewhat earlier London had been flooded with the token farthings that had been issued by the patentees to whom the crown had sold the right, and people were sometimes forced to take as much as twenty shillings' worth. It may be noted that, apart from the danger of excess, the issue of *private* tokens is subject to the great disadvantage of want of uniformity — as shown by the example quoted above. This want of uniformity is fatal to efficiency as a medium of exchange, and many of these tokens did not circulate beyond a particular street.

To protect the limitation of the coinage of tokens they are in general limited as legal tender to a certain maximum, *e.g.* in England 40*s.* for silver. This limitation also has the advantage of securing the convenience of people — they are not obliged to accept masses of silver.

The recent experience of many countries shows that the limitation of legal tender is not essential to token money if the coinage is strictly limited; and as regards the convenience of people, it is found sometimes that there is a deficiency of silver. The aim of the government is not profit, but to answer the requirements of trade, and the estimates may be underrated. Recently, in some of the manufacturing towns of England there was a dearth of farthings, to the inconvenience of the poorer classes. The sole object of token coins is to promote the convenience of people. Were it not for this, all the coins might be of gold, and the gold penny would be about the weight of half a grain of wheat.

3. Inconvertible Notes. — Inconvertible notes, as the name implies, are bank-notes, the conversion of which into coin (*e.g.* gold) is suspended, or indefinitely postponed. As they arise, in fact, from the degradation of convertible notes, it might be thought that the theory of convertible notes should be treated first. In fact, however, the issues and the value of inconvertible notes are determined by quite different principles, and the reason for taking the theory of inconvertible paper at this stage is that it forms the best illustration of the quantity theory of money.

The conditions under which these notes are issued conform more nearly to the original conditions of our hypothetical market than do the conditions that affect the actual circulation of gold. The notes have no value except as money, and as a rule people are reluctant to keep them for any time through fear of depreciation; in consequence they are thrown into circulation. Again, after a certain point has been reached in their issues, any further issue has an immediate effect on prices; and if we suppose that the other modes of exchange (through barter or credit) remain the same, we can apply the logical method of difference.

In nearly all cases in which inconvertible notes have been issued they have become depreciated. Such depreciation may be estimated in reference to the standard which these notes are supposed to represent (*e.g.* gold) or in reference to commodities. We may consider first the depreciation relatively to gold. As throughout monetary theory, it is necessary to adopt the abstract deductive method.

Take, then, an isolated country and suppose that to begin with it has a currency of two million gold sovereigns. Let the government issue a million of inconvertible notes scat-

tered up and down the country in payment for all kinds of things, so that the notes are effectively circulated at once. Then by the quantity theory, other things remaining the same, general prices will rise; and therefore if all prices rise, in theory gold also must rise in price, *i.e.* gold bullion; and therefore gold coins will be melted down so long as there is any difference in price (Gresham's law). Ultimately general prices will be restored to the former level, the only difference being that a million of notes has displaced a million of gold from the circulation.

At this point let another million of notes be issued; the same process will take place, and all the gold will eventually be driven from circulation. Suppose, next, that when there is no more gold in circulation another million of notes is issued, then, as before, all prices rise; but now, since there is no gold to displace the mass of the currency, it remains inflated, and according to the pure quantity theory all prices will have risen by one-half. *Inter alia* the price of gold measured in notes will have risen fifty per cent; and this premium on gold, as it is termed, is the measure of the depreciation of the notes compared with standard money.

We must now bring in various influences and conditions that modify the action of the pure theory.

Gold may still remain in circulation, the premium being recognised or allowed for when payments are made in gold. In this case it may be shown that the depreciation of the notes relatively to gold will be somewhat less, and relatively to commodities somewhat greater, than if all the gold were thrown on the bullion market of the particular country.

The paper may become depreciated before there is any excess of issues simply because it is discredited. In fact, this element of possible discredit must always be taken account of, though not, as some writers have supposed, to the exclusion of the quantity.

In the modern world no country is in reality isolated, and the gold may be exported. This is in fact the general rule ; exports of gold cannot be prevented and will probably be stimulated, because as prices rise importation into the country is encouraged, and the adverse balance will be met in the first place by the export of gold.

Finally, it may happen that in some cases the paper will not be depreciated in proportion to the excess of issues because, under the conditions prevailing at the time, more currency is required. Thus inconvertible notes are often issued in times of war or rumours of war, and at such times there is a reluctance to accept the ordinary forms of credit and the usual representatives of money. Thus there may be room for a larger quantity of notes. Again, a state of war always leads to exceptional demands for gold, and the place of gold in the currency must be taken by the notes (as in the early stages of the American Civil War).

But whatever modifications take place, the quantity is always of fundamental importance; after a certain amount of notes have been issued, no matter what the credit of the government or what the notes are supposed to "represent," they will be depreciated. The only effective safeguard against depreciation is limitation of issues. The idea of representation is only of use in checking depreciation in so far as it affects the quantity in circulation. Thus, if it is supposed that at some time the notes will be made con-

vertible, a certain number will be withdrawn from circulation, and so far this contraction of the currency will lower prices and check the depreciation. Similarly, if the issuers of the notes make them "represent" anything that is limited, — though not at once obtainable, — so far the issues will be checked. In the period of the bank restriction in England, when the directors issued their notes in response to the *bona fide* demands of trade, for a long time this "rule of thumb" limitation sufficed to stop depreciation; though it failed in the end, as the notes overflowed the natural channels of circulation.

4. The Evils of Depreciation of Notes. — The evils that arise from the depreciation of inconvertible notes are readily seen from a consideration of the functions of money.

The uncertainty of the extent of the depreciation makes them such a bad standard for deferred payments that, in spite of severe penalties, people often insist on making their contracts in terms of gold; and it must be remembered that in the modern world most exchanges involve, directly or indirectly, an element of time. Amongst the evils that arise from a depreciated standard we may notice: creditors are defrauded; trade is rendered uncertain and speculative — "commerce is dead, and betting has taken its place;" the issue of the notes is, in effect, a most unjust method of taxation, the only justification of which is its necessity at times of national urgency; there is a loss of credit at first national, and then reflected to individuals; in extreme cases there is an increase of crime through the encouragement to forgery (especially when the notes are of small denominations), and through the evasion of the

regulations forbidding the use of gold; and in the last resort even the government cannot get its work done, and cannot meet its own expenses in the notes. All of these evils were exemplified to a remarkable degree in the celebrated case of the French *assignats* at the time of the great Revolution.[1]

[1] Walker, *Money* — Part III on "Inconvertible Notes" is excellent, and has full details of important historical cases. See also Pierson, *Principles*, Part II, Chap. I. In my *Principles*, Vol. II, Book III, Chap. XV, the difficult question is discussed as to whether the premium on gold is the exact measure of the depreciation of notes relatively to commodities; in the essay on "Causes of Movements in General Prices" in *Money and Monetary Problems*, the different effects of depreciation on foreign trade are considered; see also *Bankers' Money*, Chap. II.

CHAPTER VIII

CREDIT AND GENERAL PRICES

1. Credit and the Quantity Theory of Money. — The quantity theory was stated, to begin with, under various conditions, and *inter alia*, it was assumed that there were no credit transactions. When we refer, however, to the conditions of modern industry, we are at once struck by the fact that, in the most advanced nations, the great mass of wholesale transactions and a large part of all monetary dealings are effected by forms of credit, and not by metallic money. The "clearings" of London banks now amount to nearly ten thousand million pounds per annum, and these represent only part of the banking transactions of the United Kingdom. In recent years there has been a great extension of banking, both as regards the opening of new branches and the acceptance of small accounts, involving the substitution of small cheques for metallic money in more and more transactions. The question then arises: Is there any connection at present between the amount of metallic money and the general level of prices? Or, in other words, must we include, under the quantity of money, all these forms of representative money and credit instruments of various kinds which are so much used as actual media of exchange?

The answer to these questions involves some of the most difficult points in monetary theory, many of

which have been the subject of controversy from the time of John Law (1671–1729), whose ideas on credit involved France in the greatest speculative mania on record (1719–1720).

The key to the answer is in the position that metallic money — we may now say gold — is the necessary foundation of this vast credit superstructure, or, without metaphor, that gold imposes real limits on the inflation of prices through the influence of credit. Omitting other points of controversy, the object of the present chapter is to give an explanation of this central truth, which, in some form or other, is generally accepted. As so often happens in economic reasoning, it is necessary to anticipate to some extent principles that are developed at a later stage, — in this instance the fundamental principles of banking.

2. Gold Reserves as a Limit to Credit Prices. — The gold reserves of a national banking system may be limited and economised to a wonderful degree, as is shown especially in the United Kingdom, in which the ultimate gold reserve is held by the Bank of England.

But, in spite of all economies, a certain amount of reserve is absolutely necessary for two purposes — first, to meet a possible *foreign drain*. Suppose that, with an inflation of credit and speculation, there is a general rise in prices. A stimulus is given to imports, and so far there is also a check to exports, with the result that eventually there is an adverse trade balance that must be met by the export of gold. The pressure on the reserve of the banking system leads to a check to advances, and thus to a contraction of credit, and prices fall. As will appear

later, a foreign drain may arise from very different causes; but the cause just noticed is a real cause, as is shown in the history of commercial crises.

Though not so striking in its immediate effects, the influence of an *internal drain* is equally real in imposing limits to a rise of prices through an expansion of credit. Wholesale transactions, it is true, are for the most part effected by credit documents, *e.g.* cheques or bills of exchange; and, as already observed, the cheque system has been extended to smaller and smaller transactions in recent years. At the same time, however, there is in every country a great mass of dealings which require either metallic money or some simple form of legal tender, such as bank-notes. But — to anticipate once more the principles of banking — every developed industrial country has found it desirable to place the issues of bank-notes under stringent limitations. The general effect of these regulations is that a very large reserve, in proportion to the reserve against other liabilities, is kept against the issues of notes. Accordingly bank-notes can only take the place of gold to a very limited extent. Thus the aggregate amount of legal tender is small, whilst cash transactions, for which even cheques payable on demand are not accepted, are a necessary part of the economic system, *e.g.* the payment of wages, railway fares, and purchases on retail trade. If, then, there is an inflation of prices through an expansion of trade and speculation, there is a greater demand for legal tender; wages rise, and more money is spent on railway fares and the like, and in retail trade. Thus, in the last resort, there is an *internal drain* on the ultimate banking

reserve; and, as before, advances are checked and prices fall.

Apart from both of these possible drains, we may see the reality of the metallic basis in another way. The *price* of gold is fixed by law. Accordingly if prices, and with prices money incomes, can rise indefinitely through the expansion of credit, whilst the price of gold remains fixed, there will be a great extension in the demand for gold watches, plate ornaments, etc., which can only be met either from the currency or the reserves of the banks. In a short time all the gold of the country would be used in this way if money incomes continued to rise; since gold at its fixed price might become as cheap as silver or copper which are subject to the general inflation. Such a supposition is obviously a *reductio ad absurdum*, but it shows very clearly that this *drain for direct consumption*, if it occurred, would be the most effective of all drains; and it must occur if there were no real limit imposed by gold upon the expansion of credit prices, and thus of money incomes.

3. The Limits imposed by Foreign Trade. — The limits imposed by the possibility of a foreign drain have been noticed in the last section. The influence of foreign trade may, however, be treated from a different standpoint. *Relative prices must be adjusted to relative values.* (See above, Chap. I.) This principle applies, not only to any one country, but to what may be termed a system of countries connected by commercial relations. After allowing for *quasi*-permanent and special causes of difference, *e.g.* protective duties and cost of transport, the level of prices in any one country cannot remain above the general level of the other countries connected with it by commerce.

The truth of this interconnection or sympathy of prices is seen at once in the case of any of the great staples of international trade, *e.g.* wheat, cotton, etc. After allowing for cost of transport and the like, the prices tend to equality in all the great markets. But the same thing is true of all commodities that can be readily bought and sold and of which the cost of transport is not very great. Any difference of price stimulates foreign trade — in fact, this is the proximate cause of all foreign trade.

But this same principle of the adjustment of prices to values shows that, if any large group of things is subject to (say) a fall in price, then other things will fall in sympathy. Thus a fall in agricultural products, *e.g.* wheat, induces a fall in farmers' profits and rents, and contracts the demands of the agricultural interests for other things. Again, a fall in wheat or wool affects directly the various substitutes, and so on through the whole range of commodities there is a sympathetic action, and thus even things that are incapable of transport, such as lands and houses, may fall in price through the effects of foreign trade.

By these and similar reasonings it may be established that the price level in any one country is a function of the general level of the commercial world.

4. Conclusion of the Quantity Theory of Money. — We now reach a very general conclusion as regards the quantity theory of money and general prices, viz., a relative scarcity of gold, in a system of gold-using countries commercially connected, that is to say a short supply relative to the work to be done by the gold, must make itself felt in some part of these countries. Broadly, there are two

principal methods. The scarcity may affect the ultimate banking reserves at the centres of commerce, in which case it will contract credit transactions; or it may affect directly the circulating medium in the countries in which credit is little developed, *e.g.* new countries that produce raw material. But in either case there will be an interaction of prices, and the fall that begins in one country will affect other countries, or must be counteracted in the country concerned. If the fall were due to the contraction of currency in the undeveloped countries, there might be an apparent glut of money at the banking centres, due to the sympathetic fall in prices and consequent depression of trade. Such appears to have been the course of events, to some extent at least, in the general fall in prices that occurred after 1875. There may be a temporary and local scarcity or glut of gold, but, on the whole, the *value of gold must be so adjusted that the demand and supply are equated*, or there is just enough to support the general level of prices.[1]

[1] On the influence of gold reserves see Bagehot, *Lombard Street ;* for the development of the argument on the interaction of price levels see *Money and Monetary Problems*, Chaps. VI–VIII, and the essay on "Causes of Movements in General Prices," *ibid.*, p. 342 (4th ed.). The argument on the interaction of gold and silver prices (here omitted as too controversial) is treated in the same essay, and in *Principles*, Book III, Chap. XVII.

CHAPTER IX

BIMETALLISM

1. Meaning of Bimetallism. — Bimetallism, as usually understood, implies that gold and silver are both legal tender to any extent at the option of the debtor, and that both are coined to an unlimited extent under the same conditions. Free coinage does not imply that there is no seigniorage (or charge for mintage), but simply that there is no limitation of the quantity coined of either metal. By way of contrast, it may be noticed that the silver coins of England are limited in both respects. In some countries at present both metals are full legal tender, but only gold is coined freely. This system is called the limping standard (*étalon boiteux*). Bimetallism also implies that government fixes the legal ratio of exchange of the gold and silver coins (fixed ratio bimetallism is thus different from *parallel standards*). Other forms of bimetallism are sometimes proposed, *e.g.* that notes should be issued against an amalgam (so to speak) of gold and silver; that is, the notes would represent so much gold *and* silver, — literally, a joint standard.

2. Instability of Bimetallism in One Country. — It is easy to show by theory and to confirm by experience the instability of bimetallism if adopted by one country only. The relative values of gold and silver in the commercial world will be determined by a variety of causes affecting the

demand and the supply. Suppose, then, that in the bullion market the commercial ratio of exchange of the two metals becomes different from the legal ratio, so that, for example, a parcel of gold coins would obtain in the bullion market more silver than is contained in the same nominal value of silver coins. Any one with gold coins could melt them down, sell them for silver bullion, get this silver coined at the open mints, and make a profit. No one would meet monetary obligations in gold at the legal ratio, and either gold would be driven from circulation (Gresham's law) or there would arise a premium on gold; which means that the ratio has broken down and that bimetallism has degenerated into a system of parallel standards. It is found on the appeal to history that a very slight difference between the legal and the market ratio, if the mints are open to both metals, is sufficient to drive the undervalued metal from circulation or to put it to a premium. Thus the overvaluation of gold to a very small degree (about one and a half per cent) by Sir Isaac Newton, when Master of the Mint in 1717, eventually led to the single gold standard, the silver being displaced. Accordingly, it is said that as regards any single country bimetallism really means an *alternating* standard, the effective standard being always that which is cheaper in commerce or overvalued as coin.

3. **International Bimetallism.** — It is maintained, however, that although any one country might not be able to maintain a bimetallic system, a combination of all the great commercial countries might do so — that is, keep both metals in circulation at a fixed ratio. The conditions implied in international bimetallism are the same

as before, in the case of one country, in respect of open mints and full legal tender at a fixed ratio; and the only difference of importance is that every nation concerned keeps its own system of *coins:* all that is requisite is that one coin at least of each metal should be of full value according to the ratio; the smaller silver coins might still be token coins. Thus *international bimetallism* is quite different from *international coinage.* The latter system involves difficulties (*e.g.* as in the Latin Union) as regards the wear and tear of the coins and the profits on token coins, that would not be found on the system proposed.

The question now to be answered is: why should a number of nations succeed where one must fail? And the answer is that over a wide area there is a *compensatory action of the double standard.* The argument is best presented by the aid of a numerical illustration. Assume, then, for the sake of definiteness, that, instead of the closure of the principal mints to the free coinage of silver, after the adoption of the gold standard by Germany in 1873, all the great commercial countries had adopted a system of international bimetallism on the lines laid down above, at the ratio which for seventy years had been regarded as normal, namely, $15\frac{1}{2}$ to 1. Could this ratio have been maintained?

The objection we have to meet is that silver would have fallen in value relatively to gold, and that gold would have been driven from circulation. Let it be assumed that at the time the amount of gold and silver in use for monetary purposes was in each case £500,000,000, and that whilst the production of gold remained at about £20,000,000, that of silver rose to £60,000,000 per annum.

Suppose that the use of gold for other purposes absorbed £15,000,000, thus leaving only £5,000,000 of the new gold for monetary purposes, whilst of the new silver £40,000,000 was available for money.

Under these conditions let the market price of silver, if possible, fall below that which accords with the legal ratio. Then, gold as bullion will obtain more silver than the corresponding amount of silver coins at the legal ratio; and naturally no gold will be used at the nominal value for coins, and no new gold will be minted. The melting of gold coins and the cessation of gold coinage will go on so long as any divergence exists between the market and the legal ratios.

According to the figures taken all the gold would be driven from circulation in about fourteen years, that is, supposing all the available silver is devoted to the purpose. So far, then, it seems as if the ratio could not have been maintained.

But a point of vital consideration remains: What is to become of all this gold as it is displaced? According to the figures taken, about fifteen millions of new gold was used for industrial purposes, export to the East, etc. But if to this annual supply there is added annually some thirty-five millions of gold displaced from the currency by silver, this enormous increase in gold must *lower its relative value* as a commodity; and the fall in the relative value of gold will involve in the end a return to the legal ratio.

This reasoning is confirmed if we now look at silver. Under these same conditions there is an exceptional demand for silver to displace the gold, and thus silver

tends to *rise in value*. The conclusion, then, is that if there is any divergence from the legal ratio (say, a depreciation of silver), the increase in the *supply of gold* displaced from the coinage, and the increase in the *demand for silver*, to take the place of the gold in the coinage, must very soon restore the ratio. This, as indicated, is called the *compensatory action of the double standard*.

4. Difficulties of International Bimetallism.—The argument of the preceding section is generally admitted to be sound, even by those who object to the proposed system on other grounds. The principal practical objections to the system may be considered from the point of view of the United Kingdom, to whose opposition the failure of the proposed convention was mainly due.

It was said that the change proposed was "tremendous." To this objection it was replied that in effect the system was only a reversion to that which was practically, though only tacitly, in existence before 1873. A sufficient number of countries up to that time had adopted bimetallism to insure the maintenance of the ratio of $15\frac{1}{2}$ to 1 with variations within very narrow limits for seventy years. Even the Bank of England was allowed by the Act of 1844 to keep part of the reserve against notes in silver, and gold and silver were always linked together in monetary arguments as the "precious metals." The stability of the ratio survived through tremendous wars and political revolutions. It survived also through great changes in the relative proportions in the production of the two metals, *e.g.* after 1850 it was feared that gold would be depreciated, but the fall in its value relatively to silver was very slight.

Next it was objected that the commercial supremacy of this country was largely due to its gold standard, and this no doubt was one of the reasons which induced Germany to adopt the gold standard. It was replied, however, that the commercial supremacy was due to industrial causes, and that no one mentioned the gold standard, even as a contributory cause, before 1873, the year of the dislocation of the metals.

It was objected, also, that England was a creditor country, and that the interest on its loans to foreign states was due in gold, and by the proposed convention could be paid in depreciated silver. The answer was that so long as the ratio was maintained there could be no depreciation, and that the interest would be paid as before, not actually in metal, but in an excess of imports.

Finally, it was objected that there would be a tacit refusal on the part of banks and financial houses, in the light of the actual depreciation of silver since 1873, to accept it as the equivalent of gold.

And this was the objection which really proved fatal to the scheme. It was generally admitted that the system could not be even started unless with the *bona fide* and cordial approval of the banking interest; and the banking interest of the United Kingdom as a whole, though there were notable individual exceptions, was extremely hostile to the scheme. It was felt that in the face of such hostility even the fear of the depreciation of silver might suffice to give a premium to gold, and that the two metals would be only used with an allowance for this premium, or otherwise that silver would be effectively boycotted. And it must be admitted that the

essence of the compensatory action lies in the possibility of using both metals without hindrance for monetary purposes at the fixed ratio.

5. The Advantages claimed for International Bimetallism. — The first advantage claimed for the system, if it could have been introduced and effectively maintained, was that it would counteract the tendency to the appreciation of gold through lessened production. This argument has lost its force through the enormous increase in recent years of the gold supplies. If the former rate of production only had been maintained, the adoption of the gold standard by so many countries would no doubt have caused serious difficulties through the "scramble for gold" (Goschen).

Next, it was maintained that, if both metals were in full use at the legal ratio for all kinds of payments, the great banks of the world could keep up and manage their reserves much more easily, and the rates for money would be lower and more uniform. And in support of this view it may be said that at present gold is hoarded in Europe in useless masses, whilst in India there is often great monetary stringency which cannot be relieved under the present system.

In the same way it was argued that bimetallism would facilitate the operations of the foreign exchanges and render the fluctuations much less severe. This argument is also quite valid and generally admitted. And it may be added that, so long as about half the commercial world has a silver standard and the other half gold, any depreciation of one metal, say silver, must have serious effects on the levels of general prices, and thus cause a real dis-

turbance of contracts and introduce a new element of uncertainty into commercial transactions.

All these advantages claimed for bimetallism were both real and considerable, but their force has recently been diminished by important changes in the monetary situation. Such are the enormous increase in the supplies of gold, and the effective adoption of the gold standard throughout the commercial world. Under these conditions, to revert to the ratio of $15\frac{1}{2}$ to 1, in the face of a market ratio of 30 or 40 to 1, would not only be impossible practically, but would lead to such monetary disturbances as would more than neutralise any possible advantages; and there is always the difficulty of agreement as to any ratio, a difficulty which was never really surmounted even in argument.

[1] *Principles*, Vol. II, Book III, Chap. XVIII, and Vol. III, Book IV, Chap. II; Walker, *International Bimetallism*; L. Darwin, *Bimetallism*; Nicholson, *Money and Monetary Problems*. The Report of the Gold and Silver Commission (1888) gives a valuable summary of the principal arguments for and against, and a résumé of the chief facts of historical importance. The annual reports of the United States Treasury give the latest and most reliable statistics on the production of gold and silver, the world's coinage, etc.

CHAPTER X

BANKS OF ISSUE

1. Development of Banking. — The best way to make clear the meaning and real importance of the principles and methods of banking is by the application of the historical method. We then see that what we consider natural and obvious was only attained by a long series of experiments, often punctuated by disastrous failures. Under modern conditions it is only in times of panic and crisis that the axioms of banking seem the dangerous paradoxes that they often actually were in the infancy of credit (cf. John Law's Bank, 1720).

The functions of banks may be divided into two main groups: the object of the *first* is to supplement, or it may be displace wholly or in part, the metallic currency by the creation of "representative money"; that of the *second* is to borrow and to lend money — a large part of which is also "representative money."

These two functions may be illustrated by reference to the Bank of England. By the Bank Charter Act of 1844 that bank is divided into two departments which are quite distinct. The issue department is under definite legal rules — in fact, the issue of notes may be said in ordinary times to be automatic. The banking department, on the other hand, is guided by the judgement of the directors as in the case of any other joint stock company.

The Bank of England is only a state bank in the sense that it is the bank with which the government keeps its accounts. The issue department, however, may be considered as in effect a government office, like the mint.

2. Origin and Uses of Bank-notes. — Bank-notes are a form of "representative money" (Jevons), and their uses may be connected both historically and theoretically with the functions of money. One of the earliest uses was to provide a better and more convenient medium of exchange than the actual metallic currency. Coins became clipped and worn and of uncertain value, but bank-notes always "represented" a certain definite quantity of the precious metals. This origin and use of notes is well illustrated in the case of the Bank of Amsterdam. (See *Wealth of Nations*, Book IV, Chap. III, Part I.) This bank was founded in 1609. At that time Holland was the greatest trading nation, and the great towns of Holland, especially Amsterdam, were full of the moneys of all countries in all states of deterioration. Accordingly, there was great uncertainty in the negotiation of foreign bills. The technical details present some difficulty, but in effect it was enacted, when the bank was founded, that all foreign bills of exchange above a certain sum were to be met, not in common currency, but in an order on this new state bank. The primary object of this bank was to take any money offered to it, to recoin it, and for the full metallic value to allow credit in its books. Accordingly, every merchant with foreign dealings must either have a sufficient amount of this bank money, or else he must buy it from some one who had a credit at the bank, and at first, as

Adam Smith says, for every guilder of this bank money there was actually a guilder in the bank. Naturally then, the bank money came to bear an agio, or premium, that is, it was worth a little more than its nominal value; it was secure, and did not require testing like the ordinary imperfect currency; and it could be obtained immediately, *i.e.* the merchant would not have to wait for his coin to be converted into bank money if he could buy a credit.

The consequence was that all the money taken to the bank remained there because the owner or receiver of a credit could always sell it for a little more than it was nominally worth. These circulating credits were in effect bank-notes; and they were not only a better medium of exchange, but also a better standard of value, than the metallic currency.

Early forms of bank-notes were also found useful for the *remittance of values*, and as soon as their credit was well established they were recognised as a much more convenient form of currency for this purpose than actual coins. This is well shown in the history of Scottish banking; mainly on this account the one-pound note in early times bore a slight premium in remote parts of the country. At present the rouble notes of Russia are said to be sometimes worth a little more than the silver that they represent.

In this connection it may be observed that the proportion of notes to gold in the circulation, if gold is the standard currency, and the notes are strictly convertible, is determined *solely by the convenience of people*. Thus in Scotland the one-pound note is generally preferred to sovereigns, and a few years ago, when the notes were

seldom renewed, the more ragged and dirty they were, the more readily were they accepted, apparently in this case because the possible danger of forgery was less.

Bank-notes have, however, another use and another origin. Merchants and private people found it dangerous to keep on hand large stores of metallic money. They were glad to store their superfluous money in a place of safety. In London at one time the mint was used for this purpose; but in 1640 Charles I "borrowed" the money, and although it was soon restored, the shock to credit made the merchants seek another kind of store.

The goldsmiths about this time began to receive money on deposit, and for this money to give *receipts*. These receipts may be considered as early forms of bank-notes. At first they probably actually kept the money, as in the case of the Bank of Amsterdam, but in time they found that they could lend a good deal of it and yet meet all possible demands. Thus they came to lend the deposits on interest, and in order to increase their loanable funds they sometimes gave interests on their deposits, in which case the receipts, or notes, bore interest. The first run on these early bankers was in 1667, when the Dutch sailed up the Thames, and the next in 1672; when Charles II shut up the Exchequer and would not pay the interest on his loans from the goldsmiths, or restore the principal. This repudiation caused such distress that after a time interest was again paid, and eventually the principal, of over £1,250,000, was recognised as the origin of the national debt.

The Bank of England was founded in 1694 on the analogy of the finance banks of Italy, and especially

Genoa. The primary object was to advance the capital of the shareholders to the government and to receive interest in return. The issue of notes, was so to speak, accidental (not essential to the working as in the early Scottish banks); the notes bore interest, were payable to *order*, not to *bearer*, and at first were not issued of any denomination below £20. They were thus not fitted to form a part of the actual currency like the one-pound notes in Scotland.

We may now consider the principles that should govern the issues of bank-notes in commercial countries under modern conditions, in which their principal function is to form a convenient part of the currency, though occasionally, as will appear later, they are of importance in deposit banking.

3. The Limitation of the Issues of Notes. — In considering the functions of bank-notes as currency under modern conditions, the first question that arises is whether freedom of issues should be allowed. In any case the notes would be, of course, under certain legal rules, just as are cheques. But the question is whether the banks should be left practically as free, as regards the issues of notes, as they are in the management of their deposits and advances. Or conversely, ought the government to undertake the control and management, either directly, or by imposing stringent regulations on the banks to which the function is delegated?

There are several reasons in support of governmental control. It is the recognised duty of the government to take charge of the currency according to the old saying, the *jus monetandi* is in the bones of kings. At one time, as

already pointed out, private tokens caused great inconvenience, and in a sense bank-notes may be regarded as token money. Again, the issue of the notes can be made a matter of pure routine, as at present in the case of the Bank of England. The state can secure the greatest uniformity and thus give the notes a wider circulation than if they are left to private enterprise. At present in England the notes of country banks that still by the Act of 1844 retain the right of issue have a limited circulation. The state can offer the greatest security for convertibility, both immediate and ultimate. The immediate security for convertibility is greater, because the state can hold a larger reserve; it need not look for a profit on the issues; it need not even look to cover the necessary expenses; the issue of notes may be regarded as a public function just as much as the provision of the metallic currency in which the expenses of management are borne by the government. In any case the issues of notes partake of the nature of a monopoly, and in general would yield a profit, and it is claimed that this profit ought to accrue to the nation at large. Finally, it may be said that the control of the notes does not under modern conditions check the development of banking in the other functions. In the early stages of banking the right to issue notes had important effects on the development of banking in general. (Contrast the history of banking in Scotland and in France. In the former case the right of issue led to the extension of the branch system, which was checked in the latter case by the monopoly of the Bank of France.) Under present conditions the right of issue is of relatively small impor-

tance for deposit banking; the great English joint-stock banks have no right of issue, and several of the country banks have surrendered their right.

The general conclusion, then, is that the state under modern conditions should control or strictly regulate the note issues.

4. The Denomination of Notes. — The next question is: should any limit be placed on the denomination of the notes in respect of value — that is, of course, a lower limit? In England, at present, no notes are issued below £5, whilst in Scotland the lower limit is £1 (thanks to Sir Walter Scott in the guise of Malachi Malagrowther). A few years ago proposals were made to issue notes in England for 10*s.* to replace the half-sovereign, which by wear and tear is an expensive coin. In some countries inconvertible notes have been issued of very low denominations, *e.g.* 3*d.* or 4*d.*, these notes occasionally being torn into halves and quarters for small change (like the old silver pennies). Inconvertible notes are of course on a different footing from convertible notes, but on the matter of the limit of value a reference to their usage is relevant.

As already observed, if the notes are really convertible, the proportion of notes to coin in the circulation depends simply on the convenience of people; and if it can be shown by experience or in any other way that people would prefer notes to (say) silver coins, why should they not be allowed the option?

The objections to the issue of very small notes: the liability to forgery — they are not so often returned to the banks, and people are naturally more careless. On

this point the evidence of the inconvertible notes is important, and it is well known that in this case the small notes are liable to forgery to a greater extent. The expense of these small notes is relatively great if they are convertible. They are also likely to be held mainly by the poorer classes, and in case of a panic the danger would be greater and the suffering more severe. All these objections, though of historical interest, are of minor importance to one that still remains to be noticed. It is said that if notes are allowed to be issued of low denominations, there would be greater danger of *overissue*. This objection leads to the more general question, which is also of importance as regards the limitation of the issues generally; namely, If notes are legally convertible on demand is overissue possible? The answer to this question brings out the opposition between the two great principles that have been discussed so much as regards the issues of notes, namely, the *Currency* and the *Banking* principles.

The advocates of the banking principle maintain that notes should be regarded simply as a form of bankers' credit, and should be placed under no special regulations. The supporters of the currency principle, on the other hand, maintain that the notes are not merely forms of credit, but money or currency in a special sense, and therefore require special regulations. Some of the points raised in this controversy have been discussed in a former section, but the principal problem of historical interest, and still of practical importance, is as regards this *possibility of overissue*.

Overissue is plainly a relative term, and we have to

determine the proper correlative. In the first place, it may mean overissue compared with the reserve; the contention is that, if the notes are not strictly limited, an insufficient reserve will be kept. So far as the *ultimate* redemption is concerned, there is not much to fear even if the issues are left to the discretion of bankers, and it might easily be provided for, *e.g.* by compelling the banks to hold government securities against their issues or some other form of documentary reserve.

But in the case of bank-notes such ultimate convertibility is not enough. Notes considered as part of the currency ought under *any circumstances* to be *instantly* convertible. In times of crisis and panic what is required is a certain amount of gold itself, and that immediately; suspended convertibility is for the time the same thing as inconvertibility and may lead to depreciation. The history of banking shows that there is force in this objection. Unless the issues of notes are limited, the reserve may be insufficient for *immediate* redemption; the amount of gold may be insufficient or the "documents" may be unsaleable.

In England the Bank Act of 1844 has secured the absolute convertibility of the notes. When the act was passed only £14,000,000 could be issued against securities, and for some years before 1844, the average circulation had rarely fallen below £16,000,000. For every note beyond the legal limit of £14,000,000, the Bank was obliged to hold gold. The limit of issues against securities has been gradually raised by the lapsed issues of other banks, and now stands at £18,750,000; and as there is a total issue of about £52,000,000 there is gold in the issue department to the extent of about £33,000,000.

There is thus no question that so long as the act remains in force gold will always be obtainable for notes. (Whether this gold would be only available against the notes in the case of insolvency is a legal question that fortunately is of purely theoretical interest.) It is often said that the amount of gold held by the Bank is uselessly large. It may be replied, however, that the saving of interest on some £30,000,000 is of small national importance compared with the absolute convertibility of the notes. And furthermore, this gold can be considered as an ultimate reserve available for banking purposes in case of need (as when the Bank Act is suspended by the government).

But by those who designed this act, it was intended not simply or mainly to secure the convertibility of the notes, which had never been called in question since the resumption of specie payments, but to prevent overissue in another sense. It was maintained that, if the issues of notes were not limited, they might be issued to such an extent as to cause an inflation of prices and eventually a commercial crisis.

This argument rested on the assumption that bank-notes were currency in a different way from other forms of bankers' credit; that overissues of notes, even if convertible, increased the quantity of money in circulation, and thus by the quantity theory raised prices. The idea that bank-notes raise prices more than any other forms of credit because they are "money" is undoubtedly fallacious, and the act failed to prevent crises in the way intended. Still, there is a germ of truth in the doctrine. As already seen, a certain amount of legal tender in the form of coin

or notes is required to effect certain transactions, and this requirement imposes one real limit to the expansion of prices by an inflation of credit; or, in other words, it prevents the inflation due to other causes and effected by other forms of credit from attaining the height that otherwise would be possible. It brings the crisis sooner to a head and thus mitigates its intensity. Even before 1844 it was found that any excess of issues of notes took place *after* a crisis, that is, to fill up the place of other forms of credit. And under present conditions the chief objection made to the Act of 1844 is that it prevents the Bank of England giving relief in times of pressure when legal tender is required in greater quantities. This point will call for special notice in the chapter on deposit banks.

In conclusion it may be said that the experience of all nations has shown that it is desirable to impose limits on the issues of notes, and that the banking principle is not a *sufficient* guarantee.

In a valuable chapter of Jevons's *Money* (Chap. XVIII) a reasoned summary is given of the different methods that have been adopted by different countries as regards the issues of notes. The Imperial Bank of Germany has followed the principle of the Bank of England, with the exception of adopting an *elastic limit* for issues in case of need, instead of making the government of the day responsible for the suspension of the act.

At present the banking system of the United States is in a condition that is generally considered unsatisfactory as regards the issues of notes: one of the difficulties is connected with method of a documentary reserve; another arises from the want of uniformity.

On the whole there seems to be little doubt that it is best to make notes conform automatically, after a certain point is reached, to the limits of expansion that would be imposed by gold itself under ordinary conditions.[1]

[1] Bagehot, *Lombard Street*; Jevons, *Money*; Walker, *Money*; Nicholson, *Money and Monetary Problems*, and *Bankers' Money*; Clare, *Money Market Primer*; Dunbar, *Theory and History of Banking*; Graham, *One Pound Note in Scotland*; Gilbart, *History of Banking*; article "Banks" in Palgrave's *Dictionary*.

CHAPTER XI

BANKS OF DEPOSIT AND COMMERCIAL CRISES

1. Progress of Deposit Banking. — Historically the issue of notes often precedes the institution of banks of deposit and discount, the function of which is to receive and to lend money. The principal theoretical difficulty of deposit banking is as to the interpretation of the term *money* and the limitations on the creation of bank money. "The money market of the United Kingdom is an institution of great importance and some complexity. It has gradually grown to enormous proportions, and now embraces a *fund* almost equal in amount to the sum of the national debt. This fund is *held* by the banks, is practically *at call*, and is *repayable in gold;* and yet ninety-five per cent of it is engaged in promoting the industries and the material interests of the country and the world, and only five per cent is actually held in coin." This sentence, from a paper by the late eminent banker and economist, Dr. Gairdner, presents in a striking form the magnitude of representative money under modern conditions; and it must be remembered that in ordinary times gold coin plays a small part in effecting the actual exchanges of commerce. We seem to have realised the dictum of Sir James Steuart — the predecessor of Adam Smith — that almost any form of wealth can be melted down into bank money.

To understand the progress of deposit banking we have simply to extend the ideas already applied in the case of

notes, issued against gold (or silver), to other forms of representative money, issued, so to speak, against other forms of wealth. The early banker, who at first kept all his deposits, soon found that he could safely issue notes without an actual reserve to the full extent of his obligations. It was but a step farther when he granted credit to be drawn against by means of cheques, without the intervention of notes, and only kept enough currency to meet any probable demand.

The progress of deposit banking has consisted, on one side, in making the proportion of metal that must be held smaller and smaller; and on the other side, in the extension of the field of operations to all the branches of trade and production, and more generally to all finance operations.

The actual history of banking shows that the principles that should govern the amount of reserve, and the kinds of securities on which advances should be made, were only made clear by a series of costly experiments; and the best explanation of the theory of banking in this form is its history.

Here it must suffice to indicate the limits that are imposed on the creation of "bank money" in the shape of credit other than notes.

2. Limits to the Creation of Bank Money. — It might seem at first sight, considering the enormous proportion of the forms of credit to the actual coin in the banking system, that this credit is capable of indefinite extension. It is easy to show, however, that there are very real limits. Every one who obtains credit from a bank, to draw against by cheques, must give some kind of security, which means that credit rests upon real foundations.

Next the bank charges interest on advances of all kinds; which means that those who make the demand must be willing to pay the interest; that is to say, they must be able to employ the money obtained at a profit or to meet the interest as it arises from other funds.

Lastly, when a bank gives an extension of credit to a customer, it must be prepared to meet his cheques in any form the receivers require; it may be in the form of coin to pay wages or in the form of gold for remittance abroad. Thus the advances of a bank, and of all the banks of a country together, must be limited by the available reserves. Eventually the same principle is involved as in the case of note issues. Just as deferred convertibility or ultimate solvency is not sufficient for notes, neither is it for cheques. In many of the most striking failures on record the banks have been able ultimately to meet all their liabilities, but at the time their funds have been locked up and not available.

3. The Management of Banking Reserves. — The principles that should govern banks in the management of their banking reserves have been admirably brought out by Bagehot (*Lombard Street*, Chaps. XII, XIII) with special reference to the Bank of England. Every banker must consider the *amount of his liabilities;* the *time* when they become due, whether on demand or after notice; the *intensity*, or (perhaps it would be better to say) the concentration or similarity of the demands, that is, whether the creditors are likely to be influenced by the same or by counteracting causes as regards withdrawals and deposits. He must consider how far the demands are *calculable;* and finally, he must estimate what *kind* of *reserve* will be

required to meet the demands. The term *reserve* is an elastic expression that varies according to different circumstances. In England, as Bagehot so well explains, there is a *one reserve* system, that is to say, as regards the ultimate reserve of gold. The Bank of England is the bankers' bank. If any bank has a balance with the Bank of England, that is considered as the most real part of its reserve. But the Bank of England itself does not keep these so-called reserves, but only what it considers a necessary proportion. Every bank has money due to it day after day, — a stream of money flowing in, — and this may be reckoned as sufficient to meet the normal stream flowing out. The real reserve is held against possible differences, and the differences are generally met by drawing on the Bank of England.

When we consider the case of the Bank of England in particular, and apply these general principles, at first sight it would appear that it need keep only a relatively small reserve. The principal customer of the bank is the government, and all the material facts relative to the revenue and expenditure are well known and can be provided for. Next, the payments made on account of the government are often of the kind most satisfactory to a banker, *e.g.* payments of dividends on the debt generally only lead to a transfer in the accounts — that which is paid away as dividends being returned in the form of bankers' balances. And next to the government the other banks are the principal customers of the bank. And in this case, in ordinary times, the aggregate amount is not only stable, but better than stable. Because on the threatening of any monetary difficulty the other banks wish to strengthen

their position, and therefore to increase their balances with the Bank of England.

And even in times of panic, if the panic were due to an internal drain on the banking reserves, the danger could be met by the issue of more Bank of England notes. All that would be necessary is the suspension of the Bank Charter Act by the government of the day, and already three precedents have been established. In fact, it may be said that in this country we have a constitutional elastic limit for the issue of notes. It is to be observed also that, except on one occasion, the bank, although having the privilege of extra issues, did not find it necessary to use it, because the mere announcement of the suspension of the limits imposed on the issues of notes was sufficient to restore confidence ; in the worst crises the notes of the Bank of England have been above suspicion, at any rate since the resumption of specie payments after the restriction.

All these considerations, however, in favour of a small reserve are overborne by one important factor that often dominates the situation, namely, a foreign drain may arise in an unexpected way to an unknown extent. Bagehot gives as an illustration the payment of the French indemnity after the war with Germany, which was largely made through London. A more recent example of the same kind was the payment of the Chinese indemnity to Japan. The point to notice is that these foreign drains may arise from very different causes, and they may be sudden and unexpected. The best illustration of the importance of the management of the banking reserves from this point of view is furnished by the history of commercial and financial crises.

4. Commercial Crises. — The term *commercial crisis* is generally used in an extended sense so as to include crises that are essentially monetary in their origin and principal effects. "There is said to be a commercial crisis when a number of merchants and traders at once have or apprehend they shall have a difficulty in meeting their engagements" (Mill). Essentially, then, a commercial crisis is a breakdown of credit, though it may be due ultimately to causes affecting the material production of wealth. The causes may be divided into two great groups, first, those that lead to the inflation of credit and to overproduction or speculation; and secondly, those that precipitate the collapse.

In the *first* group we may notice, to begin with, the effects of *bona fide* commercial causes. There may be an expansion of trade — beginning with one great industry and spreading to others, raising profits and wages with its flowing stream. The increase of money incomes leads to a growth of the funds available for investments. Old securities rise in price and a stimulus is given to the creation of new. There is a great outburst in the promotion of companies; many are unsound and most have overvalued their chances of success. At first the investors may look for a profit in dividends, but as speculation increases they hope to make their gains by a rise in price of the shares. Illustrations might be given from the time of John Law and the Mississippi scheme, and the South Sea Bubble, etc., early in the eighteenth century, down through the decennial crises, so characteristic of the nineteenth.

The predisposing causes may, however, be found in more purely financial causes, *e.g.* the undue extension of banking, especially when notes were not properly regu-

lated; the mismanagement of loans and of reserves; the after effects of great gold discoveries, or of the unlocking of hoards. After the lapse of a certain time the effects of former crises seem to be forgotten, and this is probably one of the chief causes of the periodicity of commercial crises.

Amongst the *second* group of causes that lead to the actual collapse are to be noticed any events that give a sudden shock to credit, *e.g.* the outbreak of war, political revolutions, repudiation on the part of a foreign state, the failure of any firm of good standing and with extended connections, and anything that affects the ultimate reserve, especially a foreign drain. A drain may arise from many different causes, *e.g.* advances of loans to foreign states; an adverse trade balance — which may be due to excessive imports through speculative causes, or to a bad harvest (of importance in former times); or there may be a deficiency of exports, owing to the too rapid conversion of circulating into fixed capital. All of these influences may be illustrated in detail from the commercial history of the nineteenth century.

And it seems probable, in spite of the improvements in the methods of banking and in the organisation of industry, that these causes will continue to operate. There is always the possibility of gigantic fraud or culpable ignorance, and the increasing delicacy of the industrial organisation involves new dangers.[1]

[1] See *Principles*, Book III, Chap. XXI; *Bankers' Money*, Chap. IV; Mill, *Principles*, Book III, Chap. XII. The earlier crises are fully described in the great work on the *History of Prices* by Tooke and Newmarch. The annual "Commercial Review" of the *Economist* and that of the *Statistical Journal* are excellent sources of reference for the later history. Palgrave's *Bank Rate and the Money Market* brings Bagehot's argument up to date.

CHAPTER XII

THE RATE OF INTEREST AND THE RATE OF DISCOUNT

1. Interest on Capital and Interest on Money. — Some account has already been given of interest as a constituent element of profits, and indirectly of loan-interest in its relations to profit-interest. In this chapter it is intended to give some account of the causes that determine the *rate* of interest. Interest for this purpose may be defined as the price paid for the use of loanable capital for a time, the capital borrowed or its equivalent being returned at the end of the time. In modern times the capital is in the first place generally advanced in the form of money, and the same money value is returned; but it is convenient to distinguish between the case in which the money is looked on simply as a means to the acquisition of capital in the form of other things, and the case in which the money is borrowed definitely for monetary purposes — as for the settlement of some prior monetary obligation. Thus a manufacturer may borrow money in order to obtain the production-capital to extend his business, or he may borrow money as in a period of crisis to meet his bills. Interest in the first case may be called interest on loanable *capital* and in the second interest on loanable *money*. As is usually the case, the distinction is one of the adjustment of emphasis : money itself is a form of capital and logically even of production-capital, and as already observed loans of other forms of capital generally are made in terms of money. But the

distinction drawn is one of importance and is expressed clearly enough in the terms employed. It is found also that interest in the first case, namely, on loanable capital (as explained), is generally for relatively long periods, whilst interest on money as such is for short periods. In this latter case, to make the distinction clear, the rate of interest may be called the rate of discount, from the principal form that it assumes in the money market. Again, it may be noticed that on some theories all interest is really a form of discount — the difference between the present and future value of a "good"; but at this stage it is not necessary to pass into the metaphysics of interest, which always has been and still is the subject of controversy.

2. Interest on Loanable Capital. — The interest on loanable capital, being the price paid for its uses, like all other prices, depends on demand and supply. Consider first the causes affecting the supply. The supply of loanable capital must vary, other things being the same, with the supply of capital in general, and this again depends on the causes already examined in the first Book. (See Book I, Chap. VIII.) We have next to consider the causes that induce people to lend their capital rather than employ it themselves or keep it idle. Amongst such causes may be enumerated the following: —

It may happen that the owners cannot employ the capital themselves — they have no industrial knowledge or opportunity. A large part of the wealth that is inherited must be invested in some form or lent to others. Again, some people can only employ a certain amount of their means in their own business, and they invest or lend their surplus profits.

The amount loanable will vary with facilities for investment. For a long time in England the field for investment was narrowed to mortgages on land, and this contraction of the field narrowed the supply. The savings of the working classes have largely increased since facilities for the investment of small savings have been extended.

As already explained, demand and supply are correlative, and according to the point of view any factor may be considered as operating on demand or supply. The extension of the field for investment is also an extension of the demand. The slightest difference in *security* affects the supply of the loanable capital. First-class securities, even at low rates of interest, may be subscribed for many times over, whilst it is not possible to float a loan involving a high degree of risk. It may be contended that we ought to consider *pure* interest apart from the insurance against risk. Logically this may be admitted, but at the same time it is convenient to consider security as one of the causes affecting the willingness of people to lend their wealth, and to increase the supply of loanable capital.

The supply of loanable capital depends partly on its *mobility* or the reverse. It may happen that a large part of capital is in a highly specialised form, and cannot be lent for general purposes. As a rule, loanable capital must be lent in the first instance in the form of money. Capital lent directly in other forms, the particular things (with or without an allowance for depreciation) being returned, must be considered as yielding profit-interest rather than loan-interest as here under-

stood. The rent of houses, for example, is divided into ground rent and building rent; the former is of the nature of economic rent, and the latter is of the nature of profit on building. And similarly, in agricultural land, we may distinguish between the economic rent and the profit-rent; and generally we distinguish between profit-interest and loan-interest, although there is a connection between the two rates. This connection has already been treated from one point of view (Book II, Chap. VIII); it may now be noticed as affecting the *supply* of *loanable* capital. If profit-interest is relatively high, people are more inclined to employ their capital themselves, and the supply of loanable capital is diminished. Conversely, as the rate of profit falls, people are more willing to lend.

In some cases the influence of *law* and *public opinion* is a factor of importance. When interest in most forms was condemned by religion and morality, and subjected to legal penalties, there must have been a considerable effect on the supply of loanable capital. And this contraction of the supply no doubt so far tended to raise the rate of interest, which was still further raised by the extra risk involved. These two considerations are the standard arguments advanced against the usury laws. On the other hand, it may be said that these laws were intended in effect to regulate the abuses of monopoly, and so far they were economically justifiable.

The causes affecting the *demand* for loanable capital are multitudinous in detail, but may be arranged under two groups. The demand may be on the part of *unproductive consumers* — one of the few cases in which it is useful to retain this old distinction. In early times this

form of demand was of the greatest importance. People borrowed to anticipate revenue in order to anticipate their consumption. Estates were burdened, not to spend the capital obtained in improvements, but in entertainments or in providing for the expenses and risks of war. Under present conditions this form of demand is specially illustrated in the case of governments. Most national debts have been incurred for purposes that economically would be classed as unproductive, though it may be, as in war, for purposes of more importance than opulence. The debts of local governments are ostensibly for productive purposes to a much greater extent, but the term *productive* must receive a wider significance than is usually given to it in ordinary trade.

The demand for *productive* purposes, as just indicated, may be made by governments (especially for municipal trading), but the greater part under this heading is for industrial companies and private firms. The tendency in modern times has been more and more for business of all kinds to be carried on to a great extent with borrowed capital. And this, indeed, is one of the most potent causes of the extension of companies, as is shown by the creation of so many small companies. (See Book I, Chap. IV.) A glance over the causes just enumerated which affect the demand and the supply of loanable capital is sufficient to show that the rate of interest on loanable capital is subject to variation, and it is impossible to lay down any general proposition as regards the result and movement in the rate under present conditions.

In addition to all the causes supposed to operate in any

one country we have to take account of *international* influences. There is a constant expansion of the field for investment in new and undeveloped countries consequent on the improvements in communication and in security. On the other hand, taking a broad view, capital seems to be increasing in old countries much faster than labour, and in consequence the share of capital in the annual produce so far will tend to increase. (See Book IV, Chap. IV.)

3. Interest on Loanable Money — the Rate of Discount. — We may now consider the rate of interest for loanable money as such, and especially the "money" of the money market. The need for a special examination may be shown by an illustration. During the last fifty years, in England, the rate of interest on first-class securities of a permanent character has oscillated within narrow limits, about three per cent if we take the yield to consols on the purchase price as typical; whilst the minimum rate of the Bank of England, to take the typical example of interest on short loans, has varied between ten per cent and two per cent. It is true that the price of consols is subject to peculiar influences, *e.g.* the special demand for trustee purposes; but the difference between the yield to consols and that to (say) railway debentures or first-class mortgages has probably never exceeded one per cent, whilst the market rate of discount has diverged much more widely from the bank rate.

The difference between the rates on *capital* and *money* cannot be explained by a difference in security. In both cases the security may be considered perfect. The Bank of England does not make advances except on first-class security, and the credit of the British government is not

indicated by the fluctuations in the price of consols. The reason of the difference in the two rates is that they depend on different causes.

We have now to examine the causes that affect the supply of loanable money as such. Here, as throughout this part of the subject, the difficulty arises from the elasticity of the term *money*, not for purposes of verbal definition, but for practical purposes.

Consider the supply of money that is lent and borrowed in the money market. In the words of Mr. Clare, cheques and bills form the principal currency of this country. Money consists of a relatively small foundation of metallic money and notes, and a large mass of representative money, or of different forms of credit that for various purposes are accepted as money and fulfil the functions of money. Money may mean gold in the Bank of England or a cash credit in a branch bank in some remote village in Scotland. Similarly the demand for money is equally elastic. Sometimes the demand may be met by some form of credit; sometimes it is a demand for gold, and nothing else will suffice.

The causes that affect the demand and the supply of loanable money are so intimately connected that they may be taken together. The most important cause affecting the rate of discount or the rate of interest on money for short periods is the *state of credit*. Any sudden contraction of credit from any cause at once diminishes the available supply of money; and at the same time also it increases the demand. The banks have less to offer and their customers require more.

Next to the state of credit, we may notice the amount of the ultimate *real reserve*, in this country the gold held

by the Bank of England for banking purposes. (This reserve is held by the banking department for the most part in the form of notes, but these notes can at once be exchanged for gold in the issue department if required.) If the real banking reserve falls below a certain point, which of course varies according to circumstances, a crisis is inevitable; and the most marked symptom in general of a monetary crisis is a great rise in the bank rate. It is not the absolute amount of the reserve that is of importance, but the *proportion of reserve to liabilities*. This has been well shown by Mr. Palgrave in his work on the bank rates of England, France, and Germany.

The amount of this reserve itself depends on various causes, some of which operate directly on the bank rate as well as indirectly by affecting the reserve. Sometimes the reserve may vary greatly with but little effect on the rate, as when the cause of the withdrawal is well known, and a reverse flow may be anticipated. Thus the payments of dividends by government and the remittance of gold to Scotland at the "terms" may have little effect on the rate, because it is expected that the gold will soon be returned. At the same time these regular demands, although for temporary purposes, tend to aggravate the effect if they happen to coincide with withdrawals of an exceptional character. "All the normal movements of the currency are so well known as to be matters of newspaper notoriety, and the foreknowledge deprives them of their importance. The Bank knows, for instance, that gold will be wanted for Scotland at stated periods, and can therefore provide beforehand for the withdrawal. The market also knows it, but, being aware also that the gold

is still in the country and will soon be back, regards the outflow with indifference. The same is true of other cases, and it may be laid down as a rule that the ordinary movements of the currency, being foreseen, are provided for in anticipation and rarely have effect on the bank rate. At the same time, if an outflow for home requirements should happen to coincide with a demand for export, the effect of the latter will be to that extent aggravated; and in this connection it is worthy of remark that the panic of 1857 occurred towards the middle of November and that of 1866 towards the middle of May, just the periods when the Bank had been weakened by the Scotch withdrawals." (Clare, *Money Market Primer.*)

Amongst the causes that affect the amount of the reserve and also the rate directly is the *activity of trade.* A rise in the bank rate after a long period of low rates is often one of the best signs of a revival of trade. More currency is required for wages, retail trade, etc. The course of foreign trade may have much greater and more sudden effects. Any excess of imports over exports not accounted for by the other elements of indebtedness (see below, Chap. XIV) constitutes an unfavourable balance that may have to be met by the actual export of gold. An unfavourable balance of trade is no measure or sign of any disadvantage to the nation in the way that the mercantilists supposed, but under certain conditions it may be of great importance to the banking interest and thus indirectly to the nation. In itself the excess of imports is an advantage: the nation has so much to consume; but if the consequent stringency of money causes a disorganisation of trade the advantage may be more than neutralised in the end. (See Chap. XIV.)

One other point may be noticed briefly, to avoid any misunderstanding. The bank rate has been taken as typical and representative of the rate of interest for loanable money as such; at times of pressure in the London money market its influence may be supreme, but at other times there may be considerable differences between the bank rate and the market rate; a matter of much importance when the Bank is trying to attract gold from abroad by raising its rate. The technical differences between discounts and interest on loans do not require notice in a discussion of leading principles.

4. Causes of Difference in the Rates for Long and Short Periods. — In considering the causes of the difference between the rates of interest for long and short periods, we may, as before, take as typical the yield on the purchase price of consols and the minimum bank rate respectively.

Suppose interest on investments is higher than interest for money as such. The question is: why should the banks go on lending "money," it may be for months, at *two* per cent or less whilst they could get three or more per cent on perfect securities? The answer is that the banks can only lock up a certain amount of their funds in these permanent investments — even consols. The difficulty is that, if they had to realise at all suddenly, they might lose more on the fall in price of the stocks than they would have gained in the time by the difference in interest. This applies to the best securities (*e.g.* consols), and still more to those below the first rank, in which the yield of interest is higher.

The low rates for money may be a sign of a want of

confidence, as after a crisis there is little effective demand for money as such owing to the stagnation of trade.

Consider now the case when interest for money is higher than interest on investments for long periods, *e.g.* the bank rate higher than the yield to consols. Under these conditions the supply of money as such is relatively small, and the demand is relatively great, as in a contraction of credit in the development of a crisis. At such times what people require is money as such, and not capital in other forms. This consideration also explains why it is that the banks cannot increase the available supply.

At the same time there is a reciprocal action between the two rates, the nature of which is best seen in ordinary times as distinct from times of crisis. If the rate for money is likely to be low for a long period, the banks, as a whole, will try to increase their holdings of first-class securities, which give a better yield in interest, and under the circumstances offer the chance of a rise in the capital value. Conversely, a rise in the rate for money stimulates the sale of securities. With a fall in the bank rate consols tend to rise in price, and with a rise in the bank rate tend to fall. Indirectly, then, any cause that affects the ultimate reserve may indirectly affect the rate of interest on permanent investments.

In former times, when the home harvest was of more importance than at present as regards our food supplies, any deficiency in the harvest might cause an adverse balance of trade, and thus lead to a drain of gold and a rise in the bank rate; and the anticipation of such a rise might indirectly affect the price of consols. Thus it was no uncommon thing in the summer months to read that, owing

to the continued bad weather, consols had fallen in price. This depression in consols was not due to the depression in the spirits of dealers on the stock exchange, or to a gloomy view of the credit of the British government, but simply to a calculation as to a probable movement of gold and its consequences.

5. The Relative Stability of the Rate for Long Periods. — A question closely allied to that discussed in the last section is this: why should the yield to first-class securities (say consols) remain practically steady for long periods, whilst relatively there are violent oscillations in the rates for short loans of money? The rate of interest in the first case is, no doubt, also subject to change, but the point is that the changes are *relatively* slow, and within narrow limits.

The essence of the answer seems to be that all investments that offer equal security, are equally marketable, easily transferred, and, generally, possess equal net advantages, must give approximately the same yield. The quasi-permanent differences mark differences of advantage. Just as in the case of wages (other things being the same), the more insecure and troublesome the employment, so much the higher the pay, so also in investments. On the other hand, consols have always had special attractions for trustees and others; and through being specially named in bequests, so far have a fancy price. It is probable that the extension recently of the securities available by law for trustees, and the still greater extension through the change of habits or opinions as regards the exceptional advantages of consols, have been the principal causes of their recent fall

relatively to other securities; that is, consols have lost some of their exceptional value, not on account of the war and the discredit of the government, but simply because investors, as a class, have come to give a wider meaning to the expression first-class security. At one time mortgages on land had exceptional claims to public esteem, and were supposed to be especially safe because "the land was always there."

Recently, through the whole range of securities, there has been an approximation to more uniform rates, — the yield to the first class has risen, and that to the lower classes has fallen relatively.

To return from this digression. There is a *general rate of interest* on loanable capital (as there is a general rate of wages for hired labour), there are differences in relative rates on different investments, and both are subject to changes; but the changes are relatively slow compared to the oscillations that occur in the rates for short loans. It is this tendency to equality that pervades the whole mass of interest-bearing securities that really explains the stability. The aggregate of such securities is enormous, as is seen at once by a glance through the lists of the stock exchange. Any change in the rate of interest must affect all equally, after allowing for the special causes of difference. The annual additions to the supply of securities is small compared to the mass in existence, and it is balanced more or less by the annual savings that seek investment. Thus the changes in demand and supply are, on the whole, not great, and operate slowly — that is to say, when the comparison is made with the smallness of the funds of the money market and the

violent oscillations, both as regards the demand and the supply of loanable money. In conclusion, it may be pointed out that, if we take the average of the rates for long and short periods over an extended time, say for fifty years, there is not much difference.

6. The Exchange Value of Money and the Rate of Interest. — Much attention has been directed to the discussion of the connection between the *value of money* in the economic sense of *exchange value*, and its value in the popular sense of *rate of interest*. Perhaps so much attention would not have been found necessary if other words had been employed to express the points in dispute. In effect, the question really amounts to this: What is the connection (if any) between a high or low level of prices, and a high or low level in the rate of interest? Put in this way, the obvious answer would seem to be that there is no connection whatever. A survey of monetary history would show that the rate of interest is sometimes high with high prices, and sometimes the reverse is the case. And a reference to theory raises the presumption that a change in the measure of value must affect equally all prices, including the price for the use of loans. Or we may apply the general principle that relative prices must be adjusted to relative values, and say that the demand and the supply of loanable capital are so far unaffected by any movement in general prices.

This argument seems quite sound, with the proviso which was found to be necessary in the general theory, namely, after time has been allowed for the readjustment. In other words, in the period of transition from one level of prices to another, there may be an effect on the rate of interest.

The principle involved may be best explained in the case of inconvertible notes, in which we can observe in the most marked manner the effects of changes in price levels.

Suppose the notes are issued by the government in such a way that prices are directly affected, as when the notes are scattered up and down the country in the payment of governmental expenses. All prices rise, and so far there is a stimulus to trade and a demand for loans from the banks. In this case, however, there is nothing in the mode of issue to increase the funds of the money market, and thus the rate of interest rises with the rise in prices. Suppose, however, that the government issues the notes in the first place to the banks, and the banks throw them into circulation by making advances; in this case the rate of interest will fall, and prices will still rise.

The same principle may be applied in the case of great gold discoveries — although here the effects are not so sharply defined. If the new gold is thrown directly into the channels of circulation, and raises prices and stimulates trade, then this increase in the supply of gold will be accompanied by a rise in the rate of interest. If, on the other hand, the new gold is first thrown on the loan market, for the time it will lower the rate of interest on money, though, as before, prices will rise.

Conversely, in the case of a fall in general prices, or an appreciation of gold, if the fall of prices is due to a direct contraction of the currency in the outskirts of commerce, then there may be an apparent abundance of money in the banks at the great centres, and the rate of interest may be

low. If, on the other hand, the scarcity of gold is first felt at the centres, the rate of interest will so far rise.[1]

[1] *Principles*, Book III, Chap. XXII; on the metaphysics of interest, and the history of opinions, see the works of Boehm-Bawerk, translated and edited by Smart; on the money market, Bagehot, *Lombard Street;* Jevons, *Money;* and Jevons, *Investigations in Currency and Finance;* Clare, *Money Market Primer;* Nicholson, *Bankers' Money*, Chap. III; Giffen's *Essays in Finance;* Palgrave's *Bank Rate and the Money Market.*

CHAPTER XIII

THE THEORY OF FOREIGN TRADE

1. The Problems of Foreign Trade. — The subject of international or foreign trade is one of great complexity. It includes the pure theory, the object of which is to bring out the principles by the aid of hypotheses and the use of the abstract deductive method; it also embraces an account of the foreign exchanges, than which there can be nothing more definite and practical; it involves the consideration of the real advantages and possible disadvantages of foreign trade and the application of the results to the opposing policies of free trade on the one side, and the various forms of protection, preference, monopoly, or the opposite of free trade, by whatever name it happens to be called by the fashion of the day. Each of these branches of the subject has difficulties of its own. Any one who is inclined to think that the use of hypotheses and the abstract method involves simply the setting forth of a few self-evident truths may be invited to peruse Mill's "stupendous" chapter on international values, and then to compare the critique by Cournot with the rehabilitation by Professors Edgeworth and Bastable (who again differ in certain respects). The very object of this pure theory is to explain the operation of the economic forces which govern the actual trade of the world; and the use of the abstract method is not to deal with imaginary examples

from an imaginary world, but to make the principles of this world of ours as clear as possible by abstracting or taking away circumstances that are not essential.

Such being the complexity and difficulty of the subject, the main object in the present chapter will be to set forth what is generally accepted as clearly as possible, and to indicate where the by-paths of controversy leave the main track without pursuing them very far.[1]

2. Meaning of Foreign Trade. — International trade, as the name implies, refers to trade between different nations. As in the case of most economic conceptions, so in distinguishing between "domestic" and "foreign" trade we must leave a debatable margin. If we compare two "nations" with two "places" within the same country, the following are the chief points of contrast: —

The two nations are politically independent and the respective governments may impose various restrictions on imports and exports; labour and capital move with comparative difficulty between two countries owing to various causes, such as distance, differences in language, religion, social customs, love of home, etc.; the two nations have different monetary systems, and payments are made for the most part by means of bills of exchange founded on the actual transactions of commerce. These differences are, it will be seen, only differences of degree, and it is not necessary that all should be present in every case to constitute foreign trade. Stress is laid on differ-

[1] In the treatment in my larger work, Vol. II, Book III, Chaps. XXIII-XXVIII, a somewhat different order is adopted for the reasons there given; and some of the problems are discussed in Book V, Chaps. XIV, XIX, after the treatment of the principles of governmental control and taxation.

ent elements in different problems; in free trade and protection the political elements are of importance, whilst in the pure theory of foreign trade the comparative immobility of labour and capital is predominant; again, in the pure theory money is either excluded or the same standard is applied throughout, whilst in the foreign exchanges a large part of the subject is concerned with the exchange of different moneys.

3. The Pure Theory of Foreign Trade. — In the pure theory, as just indicated, the chief point of distinction between home and foreign trade is in the difference in the relative mobility of the productive powers. We assume to begin with that within any country or nation the mobility of labour and capital is perfect. In other words, capital and labour flow readily to the districts in which their productive power is greatest. If, for example, owing to natural or acquired advantages, one place with a given amount of labour and capital can produce more than any other place in that country, the industry will be localised in that favoured locality. And as we have seen (Book I, Chap. III), there is actually in every country a tendency to the localisation of industries, and the hypothesis of the theory is approximately true.

A country considered as isolated produces a great number of products; it has a variety of extractive industries, such as agriculture, mining, fisheries, etc., and a variety of manufactures in the broad sense of the term. It is assumed that, as the result of competition and mobility, the capital and labour will be so distributed as to give the best return. The controlling force in this distribution is the tendency to equality of real wages and real profits,

per unit of productive power or efficiency. In comparing real wages in different places and employments in the same country, for the purpose of theory, we may take *time* as the unit of measurement of the *labour* and *money* (of uniform purchasing power) as the measure of the *reward*. If the labourers find that they can obtain more money for the same number of hours of labour in the towns, they will migrate thither from the country. Similarly, the makers of goods in the towns will flock to the district in which the reward is highest. In the same way capital will be attracted to, or repelled from, certain trades or places, according to the profit to be obtained.

In the markets of any one country it is assumed that the same prices prevail for the same qualities of goods. If, then, it should happen that, owing to any reason, it takes more labour and capital to put goods on the market from some place, than from others in which the thing is produced, the makers of the thing in this ill-favoured place will obtain a less reward than those in the more favoured localities. Accordingly, the producers in the first case will shift their quarters if they can, and it is assumed that within the borders of the country concerned, this is generally possible.

But when we constrast two "nations" with districts in the same country, the essential difference for pure theory is that between foreign countries capital and labour will not move at all or only with difficulty.

This assumption of the pure theory is also approximately true, at any rate over a relatively short period. The natural resources are obviously attached to each country, and the mines, the cultivated lands, the means

of communication, have large capitals sunk in them. Similarly, the buildings, machinery, and most forms of auxiliary capital are incapable of export once they have been specialised. As regards labour, the saying of Adam Smith is still true of foreign trade, "Man is of all baggage the most difficult to be transported."

Now it is theoretically possible that, owing to economic conditions, natural and acquired, one country may possess an absolute superiority over another in productive power in all its industries, or for the present purpose it may be said, in all the industries that yield commodities capable of export. Such, for example, is the case if we compare a backward country with one at a much higher stage of civilisation.

But the great staples of international trade must sell for the same prices in the world's markets. Thus the superior country for a certain amount of exports will receive a greater money reward per unit of productive power than the inferior country, and the money will buy more real things. It is, however, impossible for the inhabitants of the inferior country to betake themselves and their capital to more favoured regions; they must make the best use they can of their powers within their own borders and accept a lower rate of payment per unit of productive power.

It is, however, possible that when trade is opened with the superior country, the inferior country may gain by a redistribution of its labour and capital, within its own borders, and the lower money reward may command more commodities than it otherwise would; similarly, also, the superior country may give even greater rewards to its

producers through the redistribution of its industries, after the trade is established between the two countries. How these higher rewards are obtained is explained by the theory of comparative cost.

4. The Theory of Comparative Cost in Terms of Barter.— It is usual to state the theory of comparative cost in terms of barter, at any rate to begin with. The object is to bring out the real advantage to be gained by foreign trade; and to do this we must pass behind the money measures. In other parts of economics, as already shown, it is necessary to distinguish between the *nominal* and the *real*, as in wages; but as shown in dealing with the relation of cost of production to value, it is not necessary to refer constantly to the ultimate elements of real cost. In the same way it may be said of international values, that the theory might be worked out in terms of money, and afterwards interpreted in terms of real cost and real advantage.

It is important for the student who may be perplexed by the controversies on the best method of procedure to remember that the same ground ought to be covered in the end, whether we begin with barter or with money.

The merit of the procedure by barter lies in the emphasis that is laid on the fundamental propositions that all trade is ultimately barter and that commodities pay for commodities. We thus get rid at the outset of some popular fallacies regarding foreign trade which have sometimes governed the policy of nations and still influence public opinion. The difficulty of this method lies in the extremely hypothetical character of the conditions that must be assumed and in the transition from the pure

theory to the complexities of actual trade. This difficulty, however, is characteristic of the abstract method as exemplified already in the theory of economic rent and the quantity theory of money.

We may now notice the conditions that are usually assumed in this form of the theory.

It is assumed, then, that there are two countries only, say A and B, each producing the same two commodities only and both capable of export. This assumption is not so unreal as at first sight may appear, if the two commodities are taken as typical or representative of large groups, *e.g.* agriculture and manufactures. It is further assumed that cost of carriage and other impediments to trade in the finished or exportable products may be neglected. This assumption seems more unreal, seeing that the *raison d'être* of foreign trade has been stated to lie in these very impediments. It must be remembered, then, that the impediments refer to the passage of the *productive powers* — the land, the labour, and the capital — and not to the products. The very idea of trade must imply the actual passage of the things, whatever the impediments may be. If two countries impose heavy import duties, the volume of trade is checked, but it still goes on, unless the duties are prohibitive, and an inquiry might be made as to the effects on trade if the duties were abolished. Transport charges may be compared to transport dues.

The units of productive power are generally taken in terms of days' labour. This proviso requires careful explanation. Labour is taken as representative of the productive power of labour and capital combined. Just as we assume that the labour is applied under the appro-

priate natural conditions, so also we assume that it is applied with the appropriate auxiliary capital. In the two countries considered these aids to labour will differ even if the finished product is supposed to be exactly the same. And also the efficiency of the labour itself will be different or may be assumed to be different. Thus, if the natural conditions and the forms of capital are the same in both countries, we may still assume that the returns to the labour are different. That is to say, a day's labour in the two countries means different amounts of produce.

Let it be assumed, then, that each country can produce both corn and cloth; but that A has an absolute advantage over B in both commodities. The theory of *comparative cost* states that if the advantage of A is *equally* great in respect of both commodities *no* trade will arise, but if it has a *greater relative* advantage in one thing it will export that thing and import the other. In brief, the trade arises, not because one country can produce things at less real cost than another, but because there are differences in the relative or *comparative* costs.

We might indeed go farther, and say that in strictness the absolute cost has nothing to do with the trade. The object of the reference to *absolute* cost is simply to emphasise the necessity of bringing in *comparative* cost, just as the physicist may introduce the term *absolute rest* or *motion* to emphasise the relativity that is essential to these ideas.

These general statements may be illustrated by numerical examples. Suppose first, as regards corn, that 100 days' labour in A (with the appropriate and available natural agents and capital) will produce as much as 150

days' labour in B (with its aid from nature and capital). Also as regards cloth, let 100 days' labour in A produce as much as 150 in B. In this case A has a great advantage in both, or the productive power of its labour is much greater. But no trade will arise, because in both respects the advantage is the same.

But now suppose, *secondly*, that in corn as before 100 days in A will produce as much as 150 in B, but in cloth 100 days in A will produce only as much as 120 days in B (not 150 as before). Then A's superiority is comparatively greater in corn than in cloth, and a trade will arise; A will export corn to B, and import cloth from B.

This may be worked out in the figures taken in the following way: —

If A exports to B the produce of 100 days' labour devoted to corn, that is an amount of corn equal to the produce of 150 days' labour in B, and, therefore, it will command the value of 150 days' labour in B. (It is assumed that commodities in the respective countries, taken separately, exchange in proportion to their labour costs.) But 120 days' labour in B will obtain as much cloth as A could make at home in 100 days. Therefore, if A, instead of spending 100 days in making cloth at home, devotes this labour to growing corn and exports this corn to B, A can obtain for it the same amount of cloth which it could have produced at home and in addition the value of 30 days of B's labour.

This would be the advantage to A of the opening of foreign trade — on the supposition that B remains entirely passive and simply diverts some of its labour from corn to cloth. All the advantage of the trade will go to A.

But in the same way we may begin with B as active and A as passive. If B exports to A the product of 150 days in cloth, this will be equal to an amount that A could produce in 125 days (according to the figures taken above). It will therefore obtain in A the value of 125 of A's labour days. But with 100 of these days in A as much corn can be grown as with 150 in B. Accordingly, at the rate of exchange in A, B will gain 25 days' labour of A's commodities. Thus it will pay B to turn its labour from corn to cloth, and export its cloth to A and import corn from A. Under this supposition all the advantage of the trade will go to B.

It appears, then, that whether we consider A or B to begin the trade there are reasons why a trade should arise. But the advantage of the trade so far appears to be entirely on the side of the country which takes the initiative. There is probably always some advantage relatively to the country that takes the active part, but at present this may be put aside. Both countries may be supposed to share equally in the activity of trade. They cannot, however, both gain the whole advantage, or, in other words, the advantage of the trade must be distributed. The answer to this problem is given in the theory of international *values*. (Cf. Mill, *Principles*, Book III, Chap. XVIII.)

5. The Theory of International Values. — In my opinion it is better at this stage to introduce money as a measure. (Cf. *Principles*, Book III, Chap. XXVII.) It must suffice to indicate the principles that are applied in either case.

After the trade is established between the two countries, the cloth and corn must exchange at the same rates in each. This is obvious because cost of carriage is neg-

lected. If the rate of exchange is that formerly current in B, then A will gain all the advantage (and conversely B will gain all if the rate is the rate formerly current in A). The adjustment between these two extremes will depend on *two* considerations, one arising from the *conditions* of *demand*, the other from the *conditions* of *supply*. As regards demand, if B is very keen to obtain corn, and A is not very anxious to get cloth, the greater intensity of B's demand will make it offer more cloth. Thus the *intensity of the reciprocal demand* is one factor in the determination of the price. Again, the establishment of the trade in the way supposed assumes that in each country there is a transfer of productive power, in A from manufactures to agriculture, and in B from corn to cloth, to take the concrete form of the same argument. But as soon as we pass from the conditions of perfect mobility that are assumed to prevail in each country, some inducement must be offered in order that this transfer may take place. The advantage in the international exchange will be so far the greater on the side of the country to which the greater inducement must be offered to have the transfer accomplished.

This last consideration suggests also that other elements must be introduced as we pass from the hypothetical conditions at first laid down or tacitly implied.

Amongst these additional factors are to be noticed: the conditions of production — whether the commodities can be increased in response to the extension of the foreign demand at the same, at a less, or at a greater, cost. Thus if, as usual, it is assumed that corn follows the law of diminishing return, whilst cloth follows that of increasing

return, so far the rate of exchange established will be in favour of corn.

Another element to take account of is the relative magnitude of the two countries and the relative importance of the foreign trade in each to the total trade.

We must also introduce the complexities due to the facts that foreign trade is a barter, not of two things only, but of many things, that the cost of carriage is never a negligible factor, that more than two countries must be considered, and finally that the productive forces cannot be adequately represented by days' labour of a uniform character in each country. We have also to take account of the causes that affect the growth and the distribution of capital, and the differences in the efficiency and in the reward of labour in different employments. It is in working out the effects of these complicating causes that, in my opinion, it seems necessary to introduce money. (Cf. *Principles*, Book III, Chaps. XXVII, XXVIII.)

6. Money in International Trade. — When the trade is established between the two countries we must suppose (omitting cost of carriage) that the *prices* of corn and cloth are the same in both countries. The inducement to trade arises because at these prices the labour in each country will obtain a better reward, which may be reckoned in consuming power as regards both corn and cloth. That is, we must compare money wages and prices in each country under the old conditions and the new.

The introduction of money wages shows the importance of considering the magnitude of the countries and of the foreign trade, because in any one country the money wages in the trade that produces for export must be pro-

portioned to the general rate of wages current in that country, having regard to the special causes of difference.

The money value of the exports must equal that of the imports, and the relative prices of commodities must be so adjusted that this equilibrium is effected. Otherwise the country with an excess of imports must continuously export money, and the drain of money would lower prices until it paid to export some commodity, or not to import some other, or at the same time exports might be increased and imports diminished. This argument is of the nature of a *reductio ad absurdum*, and shows rather why such a drain could not continue if it arose, than why it could not arise. As explained in dealing with the foreign exchanges, an adverse balance may be met, not merely by the export of gold, but by the export of anything saleable for gold.

All that we can say as regards the distribution of gold, considered as the world's standard money, is that it will be so distributed, and the levels of prices will be so adjusted, that so far there will be no disturbance of relative values, or in other words, that the trade of the world is governed by real causes which are only measured in terms of money.[1]

[1] The theory of foreign trade in terms of money is worked out in *Principles*, Book III, Chap. XXVII, Secs. 4 to 11, and in Chap. XXVIII. The subject is too difficult and complex for further compression than is there attempted. Bastable's *Theory of International Trade* is an excellent monograph on the whole subject, and the critical student may refer to the papers by Professor Edgeworth, in the *Economic Journal*, Vol. IV, p. 40, Vol. VII, p. 401, Vol. IX, p. 125. The appendix to Bastable's *third* edition (1900) gives a clear and impartial account of the points in dispute.

CHAPTER XIV

THE FOREIGN EXCHANGES

1. International Debts. — The term *foreign exchanges* refers to the settlement of *international debts*. In the analysis of international indebtedness the first element to be considered is the amount of the exports and imports. As shown in the last chapter, if there were no other element in international indebtedness, imports must be paid for by exports; and this, indeed, is accepted as the fundamental axiom of foreign trade.

This balancing of exports and imports is hidden in practice by various conflicting circumstances. As Adam Smith pointed out, it is practically impossible at any time to say what is the actual balance of trade between two countries. Accordingly, what is sometimes called the *real par* of exchange in the sense of an equality of indebtedness would more properly be called the *ideal* or *hypothetical par*, which is a useful assumption in certain parts of the theory. It is altogether different from the *nominal* or *mint par*, which expresses a definite relation between the standard moneys of two countries.

It is usual to speak (as in the last chapter) of the trade between two countries (say England and France) as if the trade were run by a gigantic trust on each side or by the respective governments. Nothing, of course, could be further from the truth. It is only for brevity

of expression that we speak of England trading with France; the trade between the two countries is not conducted on the principle of two monopolists contending with one another, but by a multitude of independent merchants. "*Every transaction in commerce is an independent transaction*" (Ricardo). The reconciliation between the two positions is found in the course of prices. All prices are determined by two sets of causes. There are *relative* causes that affect the particular commodities, *e.g.* special improvements in production or special changes in demand, and there are *general* causes that affect the level of prices over a wide range; for some purposes we consider causes so general that they operate through the whole commercial world. In other cases we consider the general causes that determine the level of prices in a country, and in some cases the causes that affect the prices of certain groups of things, *e.g.* the exports or the imports. In the foreign exchanges we have to consider mainly the latter. If a particular merchant wishes to pay a creditor in a foreign country, the cost of his remittance will depend on the *general* balance of the account between the two countries at the time — not that he makes any estimate of the aggregate of debts; but there is competition between the buyers and sellers of bills drawn on the foreign country, and the nature of this competition indicates the state of the indebtedness.

Besides the exports and imports of commodities, there are other elements in international indebtedness on account of which payments have to be made. We have to take account of payments in connection with freights, stock exchange securities, the advance of loans at the

time at which the funds are remitted, the interest on the loans, the repayment of the principal, the expenses of government abroad or conversely receipts of tribute, the expenses of foreign residents, the obligations of banks, the profits on commissions of various kinds, and other minor elements.

Just as in dealing with the quantity theory of money, it was found convenient to consider all the varying influences as if equivalent to a corresponding increase or decrease in the quantity of money, so here it is convenient to translate these other elements of indebtedness into the language of exports and imports. That is to say, we should consider what would be the effect on the state of international indebtedness, if these various obligations had arisen from an increase of exports or imports as the case might be. This procedure is not only conducive to clearness, but must be resorted to when we seek to explain why it is that one country can have year after year an excess of imports over exports — apparently in glaring contradiction to the fundamental axiom of foreign trade.

The truth is we must take account of what may be called the quasi-exports and quasi-imports. Thus, for example, a freight has been well called an *invisible* export; the advance of a loan to a foreign state is, so to speak, an import of securities, and we must pay for these securities by exporting more commodities; the interest on the loans, as it is received, is equivalent to so much additional imports — we now receive imports in return for the *coupons* that we export; the expenses of our government abroad or of our absentees must be regarded as if we had to pay for so much additional imports, these imports being

consumed on the way; and finally foreigners have to pay us something on account of commissions for the settlement of various transactions which again is as if they had to pay us for so much additional exports; or these commissions are invisible exports or quasi-exports. It is owing to the balance of indebtedness on so many of these invisible exports being so much in our favour that we are enabled year after year to have an excess of imports.

It seems, then, not only that exports and imports are the principal elements in international indebtedness in most cases, but that they may be taken as typical of other forms of indebtedness; and in this way the central problem is simplified without losing in reality.

2. International Debts are payable in Money. — Although it may be taken as axiomatic that exports are paid for by imports in the extended meaning of the terms, it is equally certain that the producers of these exports are paid for them in the *money of their own country*. It is all very well to say that the coal exported from England is paid for by the wine imported from France, but there is no direct barter of this kind, and the exchange or payment is only possible through the intervention of money. The producers of English coal are paid in English money and the growers of French wine in French money; in some way or other the French consumers of English coal must pay for it in English money and they must pay this money in England (and conversely of the wine). The way in which this is done is explained by the foreign exchanges.

"The foreign exchanges are transfers from the money of one country to that of another effected by the operation of bills of exchange" (Tate's *Cambist*). It may happen

that the different foreign countries have identical currencies, but the essence of the operation is the transfer of money power from one country to the other.

It has been pointed out above that every transaction of commerce is an independent transaction; but if this means that all the transactions are settled independently, we should have a multitude of parcels of coin flowing from one country, passing in transit a similar multitude coming from this other country; and the mints of the respective countries would be constantly employed melting and recoining foreign money. To avoid all these risks and inconveniences, the foreign bill of exchange was invented, and it may be traced back to the Middle Ages and probably to classical antiquity.

To explain the use of bills of exchange in the settlement of international debts, suppose that American merchants have exported to England corn, cotton, etc., and they have drawn bills for the corresponding value on the English purchasers or importers. These bills, being drawn on London and accepted by the merchants there, entitle the American exporters to receive the money for their exports in London. But so far they would be no better off, as they would have to fetch the gold from London. But now suppose that other American merchants buy from London piece goods of the same value as this corn, etc., exported from America. They can of course settle their debts in London by sending gold, but they can settle them equally well by buying the bills from the exporters and sending the bills to London, where they can be cashed by the sellers of the piece goods. In this case there is no passage of gold at all; by the intervention of the bills of

exchange the American exporters receive American money in America, and the English sellers of cloth, etc., receive English money in London.

In the case supposed the debts are assumed to balance exactly and the time of payment to be identical, and the Americans are supposed to take the initiative as regards both exports and imports. In the actual complexities of commerce, however, the debts will not exactly balance in this simple way, and there may be more money due for American exports than for English exports (or conversely). It is this want of coincidence in the debts that gives rise to the *fluctuations* in the exchanges. But before the fluctuations are dealt with the mode in which the exchanges are quoted must be explained.

3. The Mint (or Nominal) Par of Exchange. — The bills in our illustration being drawn in pounds sterling and being sold for dollars, the first thing to consider is the relative value of the pound sterling and the dollar. This depends on the amount of fine gold each contains, and the *mint par of exchange* expresses the relation between the two standard coins in terms of their metallic value. Thus the mint par is deduced from the legal definitions of the respective standard coins. In making the comparison or calculating this mint par we may consider one coin as fixed and the other as variable. Thus, if we take the *pound sterling as fixed*, or as the basis, the mint par with the United States is 4.866 *dollars*, with France 25.2215 *francs*, and with Germany 20.43 *marks*.

If the foreign coins were being exchanged at the same spot in order to be melted down, and there were no expense in melting or in recoining, the mint par would give

the actual rate of exchange at the time at that place. But seeing that the primary object of the foreign exchanges is to settle debts at different places, we must take account of the expenses of remittance, either of the gold itself or of what will command gold. It is the variation in this expense, and the distribution of it between the two countries, that causes the *rise* and *fall* in the exchanges.

4. **Gold Points.** — Suppose that at any particular time a number of people in New York have to make remittances to London, and that a number of other people in New York are desirous of selling bills, etc., which entitle the holders to receive money in London. If the demand exceeds the supply, the price of these bills will rise. But the limit of the rise will be given by the point at which it will be just as cheap for the American debtor to send actual gold to London. This is the outgoing gold point from New York, and it is calculated as £1 = 4.89½ dollars; conversely, if the supply of bills exceeds the demand, the price falls and it may fall to such a point that it would be just as profitable for the owner of the bill — the American creditor — to send for the gold. This is the incoming gold point to New York, and may be taken at £1 = 4.83½ dollars.

To resume: the mint par is £1 = 4.866 dollars. If the rate rises to 4.89½, it generally pays to send us gold; if it falls to 4.83½, it generally pays to take gold from us. These gold points or specie points cannot of course be fixed with absolute precision, as they depend on the cost of transmitting the gold; but the average is approximately certain, and at present it is only under exceptional circumstances that these limits are exceeded. Such occasions arise when there is great stringency in the money market, or it may be fear

of a monetary crisis. (See Goschen, *Foreign Exchanges*, Chap. IV.)

5. Favourable and Unfavourable Exchange. — Fluctuations in the foreign exchanges are described as being *favourable* or *unfavourable*. The use of these terms is best explained by their history. In former times there was always much anxiety about the exchange of currencies, and it was considered an unfavourable state of the exchanges if more money of the home country had to be given for foreign money than was indicated by the par of exchange. Thus, if the imports into England had greatly exceeded the exports, there would be keen competition on the part of the importers to buy the foreign bills and the price would rise to specie point; people would give more for bills than their nominal value up to the limit at which it would be just as cheap to send gold. Such a state of the exchanges would seem to show that the English currency was not obtaining the full value in terms of foreign currency.

It would also show that there was a danger of gold itself being exported from the country, and the export of gold was considered in itself unfavourable according to the old mercantilist ideas.

In reality an unfavourable exchange is unfavourable only to those who have to send money or pay money abroad (say, the importers), but *ipso facto* it is favourable to the exporters, who are able to sell their bills for so much more. The real distribution of the loss and gain of fluctuations in the exchanges will depend on the terms of the contract of sale as between the buyers and sellers.

There is, however, a sense in which, under present conditions, an unfavourable exchange may be said to be unfa-

vourable to the country as a whole, that is, when the export of gold is such as to threaten the ultimate gold reserves of the banking system. In this case there may be a sharp rise in the rate of interest for money, and possibly a sudden and severe contraction of credit.

It is the passage of gold from one country to another under these exceptional circumstances that gives the principal interest to movements in the exchanges to the mercantile classes as a whole. To the great mass of people in this country who are engaged in business of various kinds, including banking, the movements of the foreign exchanges are of no interest whatever, except in this one particular, namely, if there is a rise or fall in the bank rate.

In considering the influence of the rate of interest on the exchanges, it is necessary to distinguish between long and short exchange. The typical instrument for settling foreign payments is the bill of exchange. If, then, this bill is not payable at sight, but (say) after three months, its present value for purposes of remittance is subject to three months' discount. Accordingly, if in New York a cable transfer on London could be bought (say) at par, that is, for one pound payable in London, at once $4.866 would be given, then for a pound payable after three months so much less would be given — and how much less would depend on the rate of discount in London. Thus at the time of writing the New York cable transfer exchange is 4.88½, and the exchange at sixty days' usance 4.85.

In certain cases the rate of interest in the country which draws the bill may be of importance in affecting the exchanges. Suppose that the rate of discount in Paris falls much below the London rate. One natural and obvious

result would be that Paris bankers would wish to send money for investment in London at the more profitable rate, and thus the exchange would so far turn in our favour. This natural and obvious influence would be intensified by a less obvious cause. Bills drawn on London by Paris, having their present value calculated at the London rate, would be a good investment for Paris bankers. Thus they would compete for these bills, not for remittance, but for investment. This extra demand, however, must also turn the exchange in our favour still more, or at least make the movement more speedy. It is, of course, the *difference* in the rates that is of importance, and shows how a rise in the bank rate tends to attract gold.

Closely connected with the rate of interest is the state of credit in both the countries considered. The documents used for remittance are credit instruments, and the typical bill of exchange rests ultimately on the credit of both the drawer and the acceptor. The state of credit is also an important factor in the determination of the rate of interest. Although for the explanation of the principles only two countries have been taken for illustration, the rates subsisting between two places will depend partly on the rates with other places. It might be cheaper to make a remittance by a roundabout method with a certain difference in the rates. The adjustment of these rates is called the *arbitrage* of the exchanges. This arbitrage tends to steady the exchanges as between any two places. Similarly, the operations of banks add to this stability by creating paper for remittance to pay for imports which are really paid for by exports at a later date.

6. Effects of a Depreciation of the Currency. — The immediate effects of a depreciation of the currency on the exchanges are easily understood simply by taking account of the premium on gold. If a sovereign will buy so many francs at the mint par, and if the francs are depreciated, the sovereign must obtain so many more in proportion to the extent of the depreciation. If the depreciation is very great, as often happens with inconvertible notes, the apparent course of the exchanges depends entirely on the fluctuations in the depreciation. The other causes are still there, *e.g.* the balance of trade, the rate of interest, etc., but their effect is hidden altogether by the premium on gold. There are also in this case no limits to the nominal or apparent rise in the exchange — that is, taking the sovereign as fixed, and the depreciated currency as variable.

Here it may be noticed that if we are considering the case of remittance *from* a country with a depreciated currency, so much more will have to be given for the bill payable in gold in the foreign country, and the price may rise to the extent of the premium on gold, plus the cost of remitting the gold. Suppose, however, that no gold is obtainable: in this case there seems to be no limit to the rise in the price of the bills. The real limits are given by the cost of sending some export that otherwise would not have been sent. Thus we have not only gold points, but also similar export points for all exportable commodities. People who have to buy gold with a depreciated currency may find that it will be cheaper to send some form of produce to the foreign country, and to purchase the gold there with the sale of the produce, rather than to buy the

gold at an extravagant premium, and in addition pay the cost of remittance.

7. Indirect Effects of a Depreciation of the Currency on the Foreign Trade of a Country. — We may now consider the effects of the depreciation of a currency on its foreign trade in general. And for simplicity the case of inconvertible notes may be taken. It may be shown that the effects will vary according to the mode in which the depreciation takes place. Suppose that the notes become discredited almost as soon as issued — that is to say, that a premium on gold arises before there is any depreciation of the notes as regards commodities or any general inflation of prices. In this case exporters *from* this country can sell their exports at the usual rates abroad, and with the gold obtained they can purchase more notes to the extent of the premium. And so long as prices do not rise to the extent of this premium, there will be this so-called bounty on exports. In the same way it may be shown that there will be a check to imports. The imports will only obtain the same prices as before, but to remit the proceeds in gold more of the notes must be given to the extent of the premium. Suppose next that the notes are issued in such a way that prices rise through the inflation of the currency before the premium on gold is established. In this case exports to the country will be stimulated and exports from it will be checked; the final result will be that the adverse balance must be met in gold, and there will in time arise a premium on gold; it is possible that the rise in the premium may be so great that there will be a reversion to the first case.

If all the parties concerned, directly and indirectly, in the export and import of commodities were to ignore the proclamations of the government as regards the use of notes, and were to persistently make all their monetary bargains on a gold basis, and if they used the notes at all, only did so at their value in terms of gold, then there would be *no effect* on the foreign trade through the depreciation. It is very doubtful if this theoretical result is ever attained in practice. The people who really pay for the imports are the consumers in the country with the depreciated currency, and the people who must eventually receive the money for the exports from this country are the producers there; and, in general, both producers and consumers are obliged to use this depreciated paper, and they do not understand fluctuations or make accurate allowance for them. Thus, altogether apart from foreign trade, it is well known that the mercantile classes often gain at the expense of the consumers, especially the working classes.

In any case the *foreign* trader may insure himself against risk by making his bargains on a sterling basis of exchange, but he cannot prevent the depreciation affecting the conditions of demand and supply in the internal markets of the country concerned; these markets are influenced by the extent and the mode of the depreciation, and indirectly they affect the foreign trade. Similar reasoning may be applied to the case of the depreciation of silver, though this case is more complicated. (See *Money and Monetary Problems*, p. 342 *sq.*)

There are other problems connected with foreign trade that are in my opinion best explained by taking into

account the foreign exchanges. Such are the effects on the balance of trade and thus on the distribution of the advantages of the introduction of some new export due to a fall in price consequent on an improvement in production. The argument adopted by Mill (*Principles*, Book III, Chap. XXI) is as follows: this new export will disturb the balance of trade; the imports to the country will no longer balance the exports, and in consequence money will flow to the country; prices will rise there and fall in the other country in response to this redistribution of the gold, and thus exports from the first country will be checked and imports into it increased until the balance is restored. If there are only two countries to be considered, and if the price levels are supposed to be adjusted directly in response to the movements of gold and in proportion to the quantities, and if various other hypotheses are made, this *modus operandi* might serve as an explanation. But when we consider that the new export may be sent to all parts of the world, and that owing to other causes the flow of gold may be in a different direction, this explanation seems to fail to meet the complexities of real foreign trade. In the same way the argument of Mill, to the effect that the respective countries gain and lose in a general way by these effects on their respective price levels, though highly ingenious and as an example of abstract reasoning very instructive, seems inapplicable to actual conditions. The case of the payment of a tribute from one country to another involves the same reasoning and the same assumptions.

The preferable view in my opinion in both of these

cases is that the adjustment of the payments is made not by any operation on general prices and the transmission of gold, but by the export of any exportable commodity that is on the "margin of doubt" as to its destination. (See *Principles*, Vol. II, Book III, Chap. XXVI, Secs. 12–14.)

8. On the Distribution of Gold throughout the Commercial World. — If we take a system of gold-using countries, the levels of prices in particular countries are adjusted to the general level throughout the system having regard to special causes of difference. Broadly speaking, gold may be sent from one country to another for two purposes. It may be sent to meet previous obligations; but it will not be so sent if cheaper modes of remittance are available. Exports pay for imports through the medium of bills, and it is only when the bills fail that gold is sent for the relatively small balance. And even as regards this balance, it may be met by sending securities or any readily saleable export. If gold is thus sent, it augments the banking reserves of one country and so far diminishes those of the other; but in general there is no direct expansion and contraction of the respective currencies, and still less is the course of international trade determined by the rise and fall of the general price levels in different countries in response to these movements of gold. The shipment of gold follows and does not determine the course of trade. But gold may also be sent from one country to another for banking requirements. If a country finds its banking reserves getting low, it seeks to *correct* the exchanges by raising its rate of discount. The movements of gold on this account are of general importance only in exceptional times.

Commercial countries are now so closely connected that we have to compare any one with the rest of the world. Any stimulus to exports or imports, due to the movements of gold, being diffused through such a wide area, is speedily lost; and on the whole the differences between domestic and foreign trade tend to become less and less except as regards political influences and tariffs.[1]

[1] The standard work on the *foreign exchanges* is that of Goschen. The only drawback is that the illustrations are for the most part out of date. This fault may be remedied by reference to Clare's *A B C of the Foreign Exchanges*. For the effects of depreciations and for a critique of the usual argument on the distribution of gold see *Principles*, Book III, Chap. XXVI, and *Money and Monetary Problems*, essay on "Movements in General Prices," also *Bankers' Money*, Chap. II.

CHAPTER XV

ADVANTAGES AND DISADVANTAGES OF FOREIGN TRADE

1. The Real Advantages of Foreign Trade. — The most obvious advantages of foreign trade are those obtained by the consumers of the respective countries. They obtain goods that cannot be produced at home, as in the exchange of the produce of the tropics for that of the temperate zones. And things that can be produced at home are obtained more cheaply and abundantly from foreign sources of supply. The second of these advantages follows from the theory of comparative cost.

Unless, then, it can be shown that the incomes of consumers are adversely affected by foreign competition, and that they fall more than in proportion to the fall in the price of commodities, there is a real gain to the consumers under both heads. It is claimed for the theory of consumers' rent (or surplus) that it measures this gain more accurately than is possible by mere descriptive methods.

When we look to the incomes of consumers the most obvious consideration is that they are for the most part the earnings of producers. And here the principle is applied that is fundamental in foreign trade, namely, that imports must be paid for by exports. Accordingly, when a foreign trade arises and displaces some commodity formerly produced at home, it is argued that if the trade is to continue, the corresponding labour and capital displaced must be

employed, in part at least, in making some export that will be taken by the foreigner in return for his export sent to us. If the foreigner does not take our new export directly, he must take payment from some country that will — otherwise the fundamental axiom of foreign trade would be contravened. It is also maintained that the rest of the capital and labour displaced from the home industry cannot in general be sent abroad and will flow to the most advantageous employment in the home country. Here the assumption is that all the productive powers of a country can find some kind of employment, if not in some things then in "other things." This argument is popularly expressed in relation to commercial treaties in the saying, Take care of the imports, and the exports will take care of themselves.

If this natural course of trade is allowed free play, every country will produce for itself and for other countries that in which it has the greatest relative advantage (or least disadvantage), and on the whole there will be a greater return to the aggregate productive powers of the world, or for the same return as before there will be a less expenditure of labour and effort.

It is also maintained that the extension of territorial division of labour and localisation of industries will, in general, increase the aggregate productive powers still more; and the real increase of wealth or leisure, to be divided between the various trading nations, will be so much greater.

Furthermore, it is maintained that this extension of the range of markets, at any rate in times of peace, tends to steady both supply and demand, and thus to steady prices, and this steadiness is further increased by the

development and inter-connection of the national credit systems. Again, this reciprocity of interest in turn strengthens the guarantees for peace and induces nations to render mutual services of various kinds, as in railways, postal and telegraphic communications, safeguards for navigation and the like. This general increase of security is shown in a marked manner if we compare mediæval with modern commerce.

There can be no doubt that these and similar advantages have been obtained by the world at large through the progress of international commerce. And in some cases, especially in that of the United Kingdom, the national progress has been increased to a wonderful degree by the development of foreign trade, especially in the nineteenth century.

At the same time it is possible that some *particular* nation under certain conditions may suffer whilst all the world gains, just as a particular district in any one country may suffer whilst all the rest of the country benefits by the transfer of labour and capital.

It may be useful to notice some of the possible disadvantages, from the *national* standpoint, that may arise from the extension of foreign trade in general, or of some particular branches.

2. Possible Disadvantages of Foreign Trade to a Particular Country. — Even from the *consumers'* point of view disadvantages may arise; as when the greater interests of the future are sacrificed to the lesser interests of the present. Thus limited natural resources of various kinds may be exploited rapidly and wastefully, so that a few years' cheapness may be outweighed by many years' dearness.

In technical language the law of diminishing return may come into play sooner and more severely in consequence of large exports, *e.g.* coal. A country that exports continuously large quantities of raw produce, *e.g.* corn, may be said to export the land itself (Carey).

Again, it is generally admitted that the consumer is not always the best judge of his own interests, as is shown in the case of material commodities by laws against adulteration and the like. It is quite possible that a cheap foreign product may be less advantageous than the corresponding dearer home product, and that it may be advantageous to prohibit the importation of certain foreign goods (*e.g.* spirits into certain new countries, opium into China, etc.).

From the *producers'* point of view theoretical exceptions may be discovered to the universal benefits of foreign trade. The assumption that labour and capital can always be diverted from an industry that is ruined by foreign competition to "something else," will obviously not hold good of the capital and labour that are specialised to a high degree. In every nation the principal trade is between the towns and the country. Now it is quite possible that the opening up of foreign markets may seriously injure either the manufactures of the towns or the agriculture of the country. Suppose that English manufactures find a ready market abroad, and that foreign food-stuffs find a ready market in England, so that there is a great expansion of trade on both sides. The balance of trade may be simply preserved by the contraction of English agriculture, and the labour and capital employed in agriculture can only be gradually and partially diverted to manufactures. The manufac-

turing classes, it is true, benefit as consumers of food; but from the producers' point of view, it may happen that the depression in agriculture more than outweighs the gains in manufacture. If there is a rapid transfer of labour, the overcrowding of cities and the depopulation of the country may deteriorate the general conditions under which work is carried on, and intensify the disutility of labour. It is notorious that the progress of English manufactures after the industrial revolution was accompanied by great social evils.

It may be recalled, in this connection, that one of the cases that Adam Smith thought worthy of the deliberation of governments, as regards the continuance of a protective policy, was when the industry threatened by the adoption of free trade gave employment to a large number of labourers. In this case he said, "Humanity dictates that the freedom of trade should only be restored by slow gradations." This is, of course, a form of the general argument of the rights of vested interests of labour and can only be used with caution.

Again, if we take the case of a new country, it will naturally turn its attention to the production of agricultural products and raw material. But this excessive devotion to the extractive industries will so far check manufactures and the growth of towns. It is possible that in the end even agriculture may suffer because there is no near market for its by-products. Most economists, including Adam Smith and Mill, have noticed this argument in favour of protection to new countries. On the other hand, it may be pointed out that there is the danger of the creation of vested interest, and that

the temporary protection begets all kinds of protection. It is possible that, at the same time, both the manufactures and the agriculture of an old country might suffer from the competition of new and rising countries. Although it is true that all trade is barter, and that commodities pay for commodities, it is also true that exchanges are only effected by the intervention of money, not necessarily as a medium of exchange, but as a measure of values. It is extremely difficult to adjust wages and fixed charges to changes in prices due to foreign competition. When it is said that foreign competition renders some manufacture impossible, it is often only true with the understanding that the old rates of remuneration are to be maintained. In the end no doubt the fall in wages must take place if rendered necessary by foreign competition, but the fall may be resisted so long that the market is lost or only partially retained. And in any case, there is the difficulty that the wages in this particular trade must normally stand in a certain relation to wages in general.

The idea on which Adam Smith so often insists, namely, that the richer the neighbours of a country, so much the better for that country, is not always and necessarily true. In effect, the richer countries may compel the poorer to become self-supporting. They may obtain their food and raw material from distant and unexploited lands, and make all their manufactures cheaper than the poorer country. The injury that may be caused to a nation by the opening up of some new trade route, or by the conversion of a roundabout trade into a direct one, has been exemplified in history by the transfer of commercial

supremacy from northern Italy to Holland, and from Holland to Britain.

It is extremely difficult in foreign trade to estimate accurately the advantages and disadvantages when we have to compare, for example, the benefit of a fall in price with the evil of the loss of employment. If a number of people lose their regular employment, or are converted from skilled to unskilled labourers, there may be little real compensation in the fact that a far greater number obtain some kinds of commodities a little cheaper. This truth was well expressed by Mr. Gladstone when he declared that the working classes would benefit more by fiscal reforms, that extended the field of employment, than by such as reduced the prices of consumable commodities. "It is a mistake to suppose that the best mode of giving benefit to the labouring classes is simply to operate on the articles consumed by them; if you want to do them the maximum of good, you should rather operate on the articles which give them a maximum of employment."

It may be recalled that with Adam Smith the fundamental test applied as regards the relative advantages of different modes of employing capital is the effect on the employment of labour within the country. The proximate cause of any change in the direction of trade is a change in the profit to be obtained. But maximum profit is by no means synonymous with maximum national advantage. Adam Smith made the difference abundantly clear; but in the attempt to make the popular argument for free trade simple and dogmatic, his complex reasonings were forgotten. The most striking illustration of the difference between profit and advantage is found in

the central position of his attack on the monopoly of the colonial trade; the root cause of the evils of that monopoly in his view is to be found in the *high rate of profit* to which it gives rise, directly in the colonial trade and indirectly in all other trades.

The popular idea that so long as the capital gave equal profits, it was a matter of indifference to the nation at large to what employment it was directed, was not only not approved of by Adam Smith, but was distinctly controverted by him. Thus, the most advantageous of all the employments of capital was in agriculture, although the profit was less than in the distant colonial trades and in the carrying trade. Of all the employments of capital, that in the carrying trade was the least advantageous to the nation as a whole, because the real advantages were obtained by other nations, whilst we only obtained the profit or commission. On other grounds, indeed, he approved of the encouragement given to that trade by the Navigation Acts, but the chief reason assigned is that defence is of more importance than opulence; that is, the Acts were approved of on political and not on economic grounds.

A similar argument to that employed by Adam Smith may be advanced by taking into account not only the quantity of the employment, but also its *quality*. It is to the advantage of a nation that its people should not be simply hewers of wood and drawers of water, but rather engaged in crafts that demand a high degree of skill. This idea was recognised by the founders of the mercantilist policy, and was developed in a remarkable way by List (*National System of Political Economy*);

but in recent times it was a favourite theme of Mr. Gladstone.

It would be easy to multiply examples of the possible disadvantages that a particular nation may suffer, although the world may gain, from the development of foreign trade in certain directions. It is even possible to show that there are cases in which the world at large might lose by the premature extension of foreign trade. (See the ingenious argument of Sidgwick, *Principles of Political Economy*, Book III, Chap. V.)

How far the government of a country by duties or bounties, by preferences or prohibitions, by commercial treaties or retaliation, may contrive to minimise such disadvantages, will depend partly, at any rate, on the wisdom and on the powers of governments. It is one thing to admit an evil; it is quite another to provide a remedy. The possible disadvantages of foreign trade may be further increased by the fiscal action of foreign states and by the action of foreign "trusts." (See below, Book V, on the economic functions of government.)[1]

[1] The literature on the subject of this chapter is voluminous. For an account of the views of Adam Smith, see introductory essay by present writer to *Wealth of Nations* (Nelson); Sidgwick, *Principles of Political Economy*, Book II, Chap. III, and Book III, Chap. V; List, *National System of Political Economy;* Patten, *The Economic Basis of Protection;* Bastable, *International Trade;* and also *Commerce of Nations.*

BOOK IV

ECONOMIC PROGRESS

CHAPTER I

THE NATURE AND MEASUREMENT OF ECONOMIC PROGRESS

1. Connection of Economic Progress with General Progress. — Just as attempts have been made to reduce political economy to a branch of a system of general sociology, so also it has been maintained that economic progress can only be understood as part of progress in general. The progress of society includes, no doubt, many factors which indirectly affect economic progress, *e.g.* religion, morality, law, art, etc.; but it is impossible to deduce the idea of economic progress from the wider idea of social progress. The idea of progress in general has always proved elusive, and perhaps the most remarkable result of the history of philosophy is that the idea of progress has in general lagged behind the reality. Nations have progressed without any idea of progress; and the progress has been very real, even in cases which we have been accustomed to regard as typical examples of stagnation. It is asserted by Professor Flint that in China there was as real progress in the actual development of thought and history as in Greece itself; but, as in so many other eastern nations, in place of any idea of progress there was only an idea of cosmical and human cycles. Again, in the mediæval period in every department of human activity there was very great progress, but there was no corresponding comprehensive idea. From the sixteenth century onward a

number of attempts were made to express the idea of progress, sometimes derived from the perfections of God and sometimes from the perfectibility of man, but none was accepted by thinkers as satisfactory.

In the latter half of the nineteenth century, however, the theory of *evolution* has been thought to give a formula which can be applied to the universe in general, and every part and process of it. It is impossible here to discuss, even in outline, the general theory of evolution. But some points may be noticed as bearing on economic progress. It will be generally admitted that the theory or formula of evolution is useful in providing a general terminology, and in suggesting lines of inquiry, methods of classification, and ideas of continuity; but so far its aid is only formal, as in the case of logic and mathematics.

The general theory of evolution provides no easy substitute for the examination of the particular evidence that every science requires. It may be said, for example, that constitutional history affords an excellent example of evolution; the formula can be applied in every detail, but it will not enable the historian to dispense with the examination of a single document. And if we accept the ideas of evolution in general, as applicable over a wide range of very different phenomena, we must be careful not to mistake vague analogy for reasoning; and we must beware more than ever of the use of inappropriate conceptions, which in all ages has been the greatest hindrance to real scientific progress.

In particular, we cannot transfer directly the ideas of biology to economics; we may, indeed, use the terms *survival of the fittest*, *reversions*, *atavism*, *differentia-*

tion, and so forth, without much danger, but we cannot descend into the mysteries of protoplasm and the nature of heredity in the lowest forms of life with any hope of obtaining light on primitive economic structures. The conclusion is that in dealing with economic progress we must deal with economic ideas and with economic facts.

With regard to the facts, it is necessary to go to the researches of the economic historians; but in dealing with historical facts it is necessary to have certain guiding ideas.

2. The Nature of Economic Progress. — The simplest idea involved in economic progress is increase in wealth. In making quantitative estimates of national wealth, we naturally adopt the monetary standard; and the first precaution is to make allowances for any changes in the value of the standard. Such a change may have arisen, if we are comparing distant periods, either through causes affecting the standard itself, as in the change in the meaning of the pound, or through any of the causes affecting its value, such as are enumerated in the quantity theory. (See above, Book III, Chap. VI.)

We must also consider the *qualities* of the things that at different times are called by the same names, *e.g.* bread, houses, cloth, etc.

Next to the increase of wealth we consider the growth of population. "The most decisive mark of the prosperity of any country is the increase of the number of its inhabitants" (Adam Smith). Even in modern times for some purposes this mark is of the first importance in national progress. It implies greater power of defence, especially with universal conscription, an increase of the combination

and division of labour, and improvements in the means of transport. In general, an actual increase of numbers shows also that the positive checks (which are comprehensively included under the term *misery*) are not keeping down the population, that there is no undue exercise of prudential restraint, and that there is an increase in the consuming powers of the people or in their real wages.

On the other hand, in estimating progress in population, the simple quantitative measurement is not enough: we may have an increase in numbers with no corresponding improvement in quality, and even with positive degradation. It is not possible, however, to obtain any simple test of improvements in quality. The only plan seems to be to take account of a number of separate factors. A good example is given in that classic work, Porter's *Progress of the Nation*, which, although dealing essentially with economic progress, describes the progress of the nation in morals and manners, not from any ideal or metaphysical standpoint, but by concrete reference to sports, drinking, theatres, and by statistics of education, crime, health, average life, etc.

Attempts have been made to obtain more precise modes of estimating the progress of population, apart from mere numbers. One of the oldest methods is to make a monetary valuation of the people. The idea is exemplified in ancient legal systems in which every person and every part of him was appraised for the purposes of compensation; there was the *wergild* for the life, and so much less for particular limbs and feelings — an outrage such as shaving the head in derision was more heavily fined than the loss of a limb. At the present day damages for inju-

ries of this kind, material and sentimental, are constantly estimated. We have only to extend the application of the principle from individuals to the aggregate to obtain an estimate of the money value of a whole population. In making such a valuation we may, as in the case of material capital, apply the ideas both of *cost of production* and of *earning capacity*. It has often been observed that the rearing and education of children involves a very real monetary cost, and estimates have been made at different times of the cost of production of the finished child. Roughly, we may apply the maxim that the greater the cost the greater the value. The prohibition of work to children under a certain age increases the cost, but improves the quality. If the education of children is paid for out of the rates and taxes, the money cost is none the less real, and may well be greater. As we ascend in the social scale, so much higher becomes the cost of professional training, and we may take account of the capital sunk in education just as much as of that sunk in land.

But, as in material capital, so also in *living* capital, cost alone does not determine value: we must take account also of earning capacity. One of the best signs of material progress is the increase in the numbers of the more highly paid forms of labour compared with the lower. (See below, Chap. V.) The wages of a nation may be arranged in a series from the lowest unskilled labour up to the highest professional skill. Population remaining the same, progress may be estimated by the relative distribution in the numbers of the classes. (A striking illustration is afforded by Giffen's essays on the "Progress of the Working Classes.")

3. Progress and Utility. — It is clear, however, that money estimates, whether of things or of people, can only show the nature of the progress of the nation very imperfectly. We must go behind the money cost and the money earnings to the real cost and the real earnings.

And first of all we may apply the ideas of utility and disutility. Under ordinary conditions we suppose that an increase in the money wealth of an individual means to him an increase of utility (or happiness), even supposing that the individual is obliged to earn the money. We suppose that the labour of acquisition will be carried to the point at which the disutility of the work just balances the utility of the gain. The same ideas may be applied to a nation. It may be supposed that every increase in its money wealth shows an increase in the aggregate utility of that wealth. Here, however, it is still more important to distinguish between total and marginal utility or, in the older phraseology, between riches and value. (See Ricardo's *Principles*, Chap. XX.)

A rise in the aggregate money value of the houses may mean improvements in size, convenience, sanitation, etc. One of the best concrete signs of progress is the increase in the number of rooms in a house and of the windows. But sometimes a rise in money value may point to a decrease in utility to the nation, *e.g.* exhaustion of natural resources with greater value of the remainders, monopolies, increase of taxation, checks on foreign trade, etc.

Conversely, a fall in price may point to an increase of utility, *e.g.* the exploitation of new sources or improvements in production. In fact, from the national standpoint

it seems best to regard an increase of cheapness as meaning an increase of utility (the root idea in consumers' rent). If the cheapness is due to better natural sources of supply, or to more effective methods of production, this is no doubt true; but for the nation there is the danger of underestimating in some cases the real cost. It is sometimes best and even necessary to leave out money. In the early years of the factory system in England the increased cheapness of the product was small compensation for the disutility of the degraded labour of the children. Exchange often conceals the real character of national production. It is true that the makers of cheap goods by degraded labour provide themselves with necessaries, and to them the utility of the money earned is very great; but from the national point of view, if we compare the disutility involved in some kind of work with the utility of the cheap product to the consumers, there may be a large balance of disutility. We must set *producers' deficits* against *consumers' surpluses*. This is illustrated in the most striking way in the old systems of slave production. And in modern times it is the basis of factory legislation and generally of the regulation by law of the conditions of labour. And logically the extension of the principle would lead up to the prohibition of certain forms of cheap labour, even at the cost of an extension of poor relief.

The general conclusion of this application of the ideas of utility and disutility to progress is that the assistance given by them is formal and suggestive rather than substantial and historical, exactly as in the case of the general theory of evolution. Just as we must go behind the money to the utilities and disutilities, so also we must go

behind these again to more definite mental and moral elements, such as those indicated above.

4. Progress in Production, Exchange, and Distribution. — Economic progress may be considered from the standpoint of the great departments, into which political economy is divided for the purpose of exposition. Progress in *productive* power, as shown by the increase of man's power over nature, is so striking and so continuous that it needs no illustration. We can trace from the earliest beginnings the development of agriculture, mining, weaving, building, etc.

Similarly of *exchange*, which logically is a part of production. We discover the same continuity and progress in the means of transport by land and sea and in the exchange of products by trade. Taking a broader view, one of the greatest agencies of progress has been the commutation of payments in services and in produce into money payments, the economic form of progress from status to contract. The history of commutation is one of the principal strands in the history of civilisation.

At present, however, it is perhaps more important to notice that in some things progress has consisted more in the complete or partial abolition of money payments and in the restraint of freedom of contract. The principle of equality before the law was only accepted with great difficulty in the most progressive nations, and on the economic side this means that justice is not to be bought or sold. Even under present conditions, however, this ideal is only imperfectly realised on account of the costs of legal advice.

The tendency of modern times has been to make a large part of education a free gift, and the ideal of social-

ism is to extend the forms of wealth, both material and immaterial, that are not to be subject to exchange.

In production and exchange in the last resort economic progress consists to a great extent in the economy of *means* to *ends*, the desirability of the various ends being supposed to be given. Progress in *distribution*, however, only seems intelligible when it is estimated according to some ethical standard, and here the difficulty is that there is no general agreement as to the ultimate test that ought to be applied. Are we to say, for example, that the distribution is best which leads to maximum happiness, or is more stress to be laid on the idea of freedom or self-realisation?

In this conflict of fundamental principles, it seems best, for economic purposes, to stop short at those *middle axioms* that are accepted by practically all systems of moral philosophy that attempt to give precision to common sense, thought, and practice. When we take a broad view, we may hope to discover signs of progress in *distribution* that will be generally admitted, just as we can discover also signs of physical health that are generally accepted in spite of the controversies that still rage on fundamental principles in medicine.

What may be specially termed the *economic principle* of distribution (as adopted in this work) may be reconciled with any system of moral philosophy. As already indicated in the second book, it is associated with or founded on the organisation and conditions requisite or conducive to production: economic distribution is that which tends to secure maximum efficiency at the minimum real cost; to proportion reward to effort; to secure the fruits of the productive agents to their creators and preservers; to

extend the freedom of individuals, and to further the development of contract. This economic principle cannot be indicated in any simple proposition because it is applied in different ways and the difference becomes more marked with the increasing complexity of the productive organisation.

As in the case of other complex economic conceptions (*e.g.* equality of taxation) it may be made more clear by a consideration of the opposite. Negatively, then, the economic principle as here understood is opposed to distribution by force or by privilege or habit or unconscious routine, as exemplified in successive systems of law and custom. All that is involved in this general statement can only be realised by the study of economic history. If we take a rapid survey of the salient features of the distribution of wealth in England at different periods, we observe through the ages that the economic principle becomes more and more the dominating purpose. In the Roman occupation distribution rested on slavery and extortionate taxation; in the Saxon economy the possession of land gave the command over labour; but from the Norman Conquest throughout the mediæval period the force of this economic principle reduced more and more the privileges of the crown, the nobility, and the church; it weakened the power of the landholders over the serfs, and at the end of the period it broke down the monopolies of gilds and corporations. The destruction of privilege was not complete, and abuses destroyed in one form reappeared in other forms. The great work of Adam Smith on the negative side was to shatter the survivals of the old ideas of distribution, and on the positive side to show the benefits

of the adoption of the economic principle. In modern times, and notably in the nineteenth century, the ideal — "to each the product of his own labour" — has been set up by those who differ greatly as to its real meaning. But this uncertainty of interpretation does not weaken, and perhaps indeed strengthens its destructive power; it is easy to see that some privilege or monopoly or institution conflicts with this ideal, though there is a divergence of view as to the best substitution.[1]

[1] The whole of Book IV is much more fully dealt with in the *Principles* than was possible in this summary. Throughout this book it is necessary to refer to economic history, and the student should not be content with mere summaries. Cunningham's *Growth of English Industry and Commerce* contains a mass of detail and has the advantage of being written without preconceived ideas; Seebohm's *English Village Community* is an admirable study of one most important side of economic progress; Ashley's *Economic History* should be read with Seebohm; for general purposes the *third* book of Adam Smith may be contrasted with the *fourth* book of Mill, to the manifest advantage of the former; the works of Loria, especially the *Economic Bases of the Social Constitution*, though they exaggerate the material side of history, are most suggestive and supplement the ordinary view; the best account of the *idea* of progress is in Flint's *Philosophy of History;* Pareto has carried to an extreme the application of the theory of evolution and the analogies of biology; of German works the first volume of Wagner is best adapted for general purposes. For the history of the theory of economic interpretation see Seligman's *Economic Interpretation of History.*

CHAPTER II

PROGRESS IN MONEY AND PRICES

1. Progress and Money. — As already shown, one of the most distinctive signs of economic progress is the continuous extension of the use of money both for valuation and for exchange. The principle of commutation, however, can only operate by a corresponding development of the mechanism of money, and of the monetary functions. Indirectly the history of money throws great light on other departments of economic progress. Even in biology there is nothing more striking than the development of the modern banking system from the primitive forms of barter. The salient points in the history of metallic money in England are summarised in this section, as history without detail is only another form of theory.

From 1066 to the great recoinage of silver in 1696 the real standard was silver, and except during the Tudor debasement (1543–1552) the ancient fineness was undisturbed. The standard measure was the pound of silver (which as explained before had taken the place of the man slave), and it was coined always into 240 pennies. At first, only foreign *gold* coins were used, but in the middle of the thirteenth century, "an age of revolution and new ideas all over the world," a native gold coinage was adopted almost simultaneously by all the nations of

Europe, and the king of England struck *gold pennies;* but the gold coinage was rather a sign than a reality till the celebrated *noble* of 1344. This beautiful coin was about one-fifth heavier than our present sovereign. It is remarkable how many events, apparently disconnected, combined to emphasise the transition from the mediæval to the modern period. The sovereign was first coined by Henry VII in 1489, and was about double the present weight.

From the first issue of gold coins they were used as equivalent to varying amounts of silver. A ratio was generally fixed by royal proclamation; and as the market ratio was constantly differing from the legal ratio, there were abundant illustrations of the fact that a double standard is an alternating standard.

The difficulty in fixing the ratio was increased by the progressive fall in the weight of the silver penny, and the ratio was of course fixed only in reference to the exchange of coins — so many silver pennies for the gold penny was the form of the first proclamation. The progressive fall in the weight of the silver penny may be accounted for by the wear and tear of the coins, the *de facto* fall in weight of the actual currency being recognised by the king; the process of this natural degradation in weight was intensified by the use of worse foreign coins, and after gold was used, there was the operation of Gresham's law. As a result, the silver penny fell from 22½ grains at the Conquest to 7½ in the reign of Elizabeth. In 1694 the silver coins in circulation had become so clipped and worn that the guineas nominally worth only 20*s.* were generally accepted for 30*s.*

In 1696 the silver coinage was restored at a cost of over three millions sterling, and in a few years was displaced from circulation by the overvalued gold coin. The effect of this overvaluation was the adoption (eventually) of the gold standard (1816). The adoption by England of the gold standard was the result of a series of historical accidents as regards the particular year and the particular weight of the sovereign. At the same time, however, in the light of subsequent history, it may be said to accord with the natural development of trade and commerce. International bimetallism is theoretically possible, and might have been advantageous if obtained without disturbance; but national bimetallism, as the history of England shows, is unstable and inconvenient.

2. Progress and General Prices. — There are continuous records for six centuries, both in England and in France, thanks to the labours of Rogers and Vicomte d'Avenel, respectively; and a survey reveals that there are movements in *general* prices, as well as great changes in particular relative prices.

With regard to general prices, it is evident from the quantity theory of money in its extended form, which takes account of many other causes besides the actual quantity of metallic money, that it is a matter of difficulty to assign the true causes to the actual movements that have taken place; and there is also a preliminary difficulty. Although from the Conquest downward, prices have been expressed in England in terms of pounds, shillings, and pence (*£ s. d.* being the first letters of *libra*, *solidus*, *denarius*), the pound being the standard unit, and the shillings and pence definite submultiples, the *metallic*

meaning of the pound itself and of the divisions of it has changed (see last section). We find also that at different times the actual currency has been different from the legal weight of the time, and that sometimes the fact has been recognised and sometimes not. It might, then, be thought that the best plan would be simply to reduce the prices in all cases to the corresponding weights of silver, so long as silver was the standard. Such a procedure, however, implies that general prices move exactly in response to changes in the weights of the standard coins. But such an exact correspondence would only be effected under the assumptions that the quantity of money was increased exactly in proportion to the diminution in weight, and that the quantity of the metallic money was the only factor that need be taken into account. Such a simple view of the movements in the value of money would only be adequate under the simplest hypothetical conditions. And it is indeed remarkable that Rogers, who made most violent attacks on the abstract method, should himself have used that method without the precautions that are necessary. It is worth while making a brief reference to the significant facts. From 1260 to 1540 the weight of the silver penny fell from 22½ grains to 10½ grains; that is to say, a pound of silver at the latter date would have made more than twice as many pennies as at the former (the silver penny being the principal coin throughout). If, then, general prices had moved in response to changes in the weight of the penny, which was the standard coin, they would, on the average, have more than doubled; and if we could take wheat as representative, wheat would so far have more than doubled in price, having regard only to

the causes affecting prices in general. But instead of any such upward movement, on the whole, prices were steady, and wheat throughout oscillated about six shillings the quarter. In order to make his prices square with the simple theory which he tacitly assumes, Rogers supposes that people actually made their bargains, not in currency, but in weights of silver, and that the penny that is quoted means an actual penny weight, according to the old standard. This opinion of Rogers has not been generally indorsed, and, on the contrary, has been distinctly controverted (*e.g.* by Cunningham and Seebohm), and it is only mentioned here to indicate the difficulty there is in dealing with general prices.

The stability of prices through the mediæval period is to to be explained only on the supposition that there was, on the whole, a *compensatory* action of the varied causes at work. The fall in the weight of the penny so far counteracted the scarcity of silver as regards production from the mines; greater rapidity of circulation and improved markets so far compensated the increased volume of trade, etc.; but this stability, which is too readily ascribed to custom, was liable to be destroyed as soon as any one factor became of dominant importance. Thus the issues of base money by Henry VIII, and later the discoveries of silver, so increased the quantity of money that prices rose to a permanently higher level.

As regards the connection of movements in general prices with economic progress, it does not appear that any causal connection can be established. No doubt if the rise in prices is due to a fluctuating depreciation or debasement of the standard, it so far is a hindrance to trade

through the uncertainty imparted to contracts. But taking the great movements in the value of the standard, first silver and then gold, it seems that the gradual break-up of the mediæval system was associated with a gradual appreciation of the metal silver, although prices remained comparatively stable as just explained; the transition from the mediæval to the modern period was associated with a rise in prices (and a fall in the value of silver); but it is clear that the influence of the rise in prices was small relatively to such causes as the discovery of America, the Reformation, the break-up of feudalism, the growth of manufactures, the invention of printing, etc. In the nineteenth century in England we have progress in some directions coincident with retrogression in others, the progress being on the whole less marked in the depreciation of the first years of the century than in the appreciation of the second quarter; whilst that of the third quarter with its high level of prices is less than that of the fourth with its low level. The balance of progress on the whole, during the century, is remarkable; but it is doubtful if it can be definitely ascribed even in part either to appreciation or depreciation considered by itself. And such a result coincides with what might be expected on theoretical grounds.

3. **Progress and Relative Prices.** — "From the high or low price of some sorts of goods in proportion to that of others in any country at any time we can infer with a degree of probability that approaches almost to certainty, that it was rich or poor, that the greater part of its lands were improved or unimproved, and that it was in a more or less barbarous state, or in a more or less civilised one"

(*Wealth of Nations*, Book I, Chap. XI). Adam Smith himself gives some remarkable illustrations of the truth of this dictum, and with the greater abundance of material now available and the greater prominence given to economic elements in general history, this mode of estimating and illustrating progress ought to become much more fruitful. The history of relative prices shows the complexity of economic conditions even in periods which we are accustomed to regard as primitive; it shows also that there is much more movement in prices than we are accustomed to associate with the supposed customary prices of the mediæval period. Even a glance through the volumes of Rogers is instructive on these two points. We find in the history of prices, in some cases, a remarkable fixity of ratios of values over long periods in spite of great oscillations, owing to temporary variations in demand and supply. Thus, for example, the average price of wheat from 1260 to 1400 was 5*s*. 10¾*d*. per quarter, and that of barley 4*s*. 3¾*d*. per quarter, a ratio of about 100 to 73; but wheat fluctuated between the limits roughly of 15*s*. and 3*s*., and barley between 13*s*. and 2*s*., and the ratios varied between 100 to 88 and 100 to 55 in different years. The great rise in general prices from 1540 to 1582 did not disturb appreciably the ratio, but from that period there were remarkable changes down to the present time, the ratio having fallen to 100 to 54 in the seventeenth and eighteenth centuries, and risen to 100 to 100 at the end of the nineteenth.

The history of relative prices is also the history, to a great extent, of the principle of substitution. We have a remarkable series of substitutions, both as regards con-

sumption and production. Even as regards the primary wants, where habit is strongest, there is a tendency to substitute the cheaper for the more expensive modes of satisfaction, *e.g.* in food, drink, clothes, fuel, etc., although for a long time, custom or fashion or ignorance may retard the process. In luxuries, in which fashion often rather favours novelties, the effect of cheapness is still more marked.

One or two other examples may be given from the history of relative prices in England. From 1260 to 1400, weight for weight, beef was twice as valuable as wheat; in the last years of the nineteenth century it was about six times as valuable. With oscillations the rise in the value of meat has been continuous. The explanation depends partly on the conditions affecting consumption; the increase in the wealth of the people generally has increased the demand for beef, especially of recent years. But in the early periods beef was relatively cheap, partly because it was impossible to keep much stock through the winter in the absence of roots, etc., so that for a time there was relative abundance, and after that time there were no sales. Again, as regards production, wheat was very costly, the yield being only six to eight bushels per acre, that is, not a quarter of the present yield. The high price of candles and the low price of leather are connected by the fact that the cattle were lean and the mortality (and yield of skins) was high. There was also a demand for candles for church offerings which had a very real meaning at a time when artificial light was so dear. One of the greatest benefits of recent years has been the introduction of cheap mineral oil. The substitu-

tion of cotton for wool, of coal for charcoal, of transport by canals for transport by road, and then of transport by railways for canals, are all examples of substitution that were proximately associated with movements in relative prices.[1]

[1] This chapter is greatly abbreviated from Book IV, Chaps. III–VI inclusive in the *Principles*. The *History of Agriculture and Prices*, by Thorold Rogers, which has just been completed by the addition of two supplementary volumes, is a storehouse of facts, but it must be used with caution. Tooke and Newmarch's *History of Prices* and Porter's *Progress of the Nation* give materials for the first half of the nineteenth century. See also L. L. Price's *Money and its Relations to Prices*.

CHAPTER III

RENT AND PROGRESS

1. Rent as a Measure of Progress. —It was a favourite doctrine with the economists of the seventeenth century (*e.g.* Petty) that a high rent was the best sign of prosperity, and that a rise in rent was a national benefit and a fall in rent an evil. From this standpoint it seemed easy to infer that whatever raised rents was beneficial, and whatever lowered rents was the reverse. In the middle of the eighteenth century the author of the *Memoirs of Wool*, even now a valuable work of reference, takes it for granted that a fall in rent is a national calamity. Accordingly he thinks that the policy of prohibiting the export of wool was to be condemned, because it lowered the price, and in that way lowered rents. "As the landed interest is the most considerable national interest, so that of pasture ground is the most considerable of the landed, and wool the principal article for the support of both." Rents came to be regarded as the principal source of the demand for commodities; if rents fell, the landlord could not pay the shopkeeper, the shopkeeper could not pay the wholesale merchant, the merchant could not pay the manufacturer, "by which means the mischief circulates," and one deficiency extends itself to an inconceivable length and produces many.

The bounty on corn was intended primarily to raise rents, and protection to the landed interest remained one of the chief objects of English commercial policy until the repeal of the Corn Laws. From that time, largely owing to the influence of Mill, the increase of rent came to be regarded popularly as an evil, although the natural and necessary concomitant of industrial progress under present conditions, an opinion which was pushed to its logical extreme in Henry George's *Progress and Poverty*. In this work we have the exact opposite of the old seventeenth-century doctrine. The landlords absorb by their rents the wealth which ought to go to the poor; thus rent is the cause of poverty; the landlords gain and "the mischief circulates."

The truth is that, as already shown (Book II, Chap. X), the term *rent* covers several totally distinct conceptions, and a rise in rent may or not be a sign of progress according to its nature and causes.

2. Progress and Urban Rents. — It may be shown by reference to economic history that a rise in the rental of land, even in and near a large city, is by no means inevitable or continuous, although under certain conditions the rise may be enormous. At first the value of suburban land depends on agricultural conditions, and the subsequent increase in value is explained by the limitation of the supply accessible for building, the rise in demand, and the failure of substitutes or alternatives. The principal element in the rent in this case is the scarcity of the land. This scarcity is sometimes mistaken for or at any rate misnamed monopoly. There may be, on the average, some degree of monopoly, that is, the individual landowners have as

regards the lessees of the land a commanding position in making a bargain; but there is no effective combination, and, on the other hand, there is effective competition.

It is possible that in the near future there may be some fall in ground rents in the cities of old and fully peopled countries. The natural scarcity of the land from the point of view of accessibility may be counteracted in two ways: first by raising the height of the buildings with modern appliances of lifts, etc. (the "sky-scrapers" of America), and secondly, by the improvement in the means of transport and of access. Even now one of the chief causes of overcrowding and of high rents in the cities is simply the prejudice of the working classes and the nature of their amusements. In time, however, the better accommodation at the outskirts and the lower rents must have an effect on the rents of the centre. The middle classes have long since migrated to the suburbs. The same causes apply, though in a less degree, to business premises. In this case, as a rule, the high rent does not mean a deduction from profits, but an equalisation of opportunities of profit.

3. Progress and Agricultural Rents. — In tracing the progress of agricultural rents from the earliest times we must remember that rents were for a long period paid in services and in produce. If we were to place a value on these labour and produce rents, we should find that the farther we go back, the more onerous they were. This is the central idea in Mr. Seebohm's great argument. In the old manorial system, which had been fully developed in Saxon times, the owner of the land was in effect the owner of the labour stationed on it; if a manor was sold or bequeathed, the serfs went with the land just as at a later date the

"souls" on the Russian estate. Each landowner had the most effective of all monopolies as against his tenants; he could take everything beyond what was necessary to keep up the supply of his living capital. Even in the reign of Edward I the writer of a landlord's *vade mecum* directs that inquiry should be made as regards the villein tenants "to what amount they can be tallaged without reducing them to poverty and ruin." The first great result of economic progress as regards rents of this kind was their diminution. The second great result, closely associated with the first, was their commutation into money payments. The commutation, on the whole, proved to be in favour of the tenant, as the landlords found to their chagrin after the Black Death; the attempt to bring back the old powers of the landlord was one of the causes of the peasant revolt, and when this attempt failed the landlords found their remedy in enclosures and sheep farms. In this latter case they strained the letter of the law and overrode the customs that had grown up in favour of the tenants. The relation of the landlord to the tenant was still that of the economic superior, even in the seventeenth century, and complaints are common of the injury to agriculture through the want of security to the tenant. Rogers, indeed, asserts that at this time in England something very like the Irish cottier system prevailed, in which the landlord takes all except a minimum of necessaries left to the tenant. In the eighteenth century the most noticeable feature is the progress of true competition rents. Those who rent land and farm with the new improvements can pay higher rents out of a real surplus than the old-fashioned cultivators can pay out of their whole earnings.

During the period of the great war the owners of land were in a favourable position, owing to the great rise in prices partly due to protection but much more to a series of bad seasons. With the repeal of the Corn Laws and the improvement of the laws affecting the relations of landlord and tenant, the end of the nineteenth century has witnessed the full effects of competition in the widest sense on agricultural rents. The landowner has been deprived by law of the remnants of his legal superiority in making bargains, and of his economic superiority by free trade and the great improvements in the means of transport. In the main, the agricultural rental of England is now paid out of the surplus profits earned by the particular portions concerned. The development of transport and foreign trade has in effect made land "free": in the sense that the elements of monopoly or the rights of private taxation which the landowners enjoyed for centuries have been destroyed, rent is paid only for superior natural advantages, and such a payment inflicts no real burden on the payer. It is well known that under purely economic influences the agricultural rentals of England have fallen as much as the rents in Ireland have been lowered by judicial intervention. In some cases, indeed, the economic rent has become negative, and the owner of the land, in order to obtain part of the profit-rent for his buildings, drains, etc., has been obliged to surrender more than the rent formerly obtained for the original and indestructible powers of the soil.

4. The Effects of Improvements on Agricultural Rents. — In considering the effects of improvements on rent, owing to the complexity of the subject, it is necessary to

adopt, in the first place, the deductive or abstract method. Accordingly, the theory of economic rent, as given in the second book, will be taken for granted, together with the assumptions as regards an isolated country, etc., requisite to make it true. The improvements must be supposed to be general, and we have to take first the *immediate* effects. The improvements may be of different kinds. The principal effect of improvements in transport is the substitution of superior land for land inferior in productive power. The improvements so far counteract inferiority of situation. Thus the margin recedes, produce-rents fall, and rents measured in money fall still more. Similarly, also, the improvements in transport will enable the better lands to be cultivated to a higher pitch, and the marginal cost on all lands will diminish with the fall in the expense of obtaining materials and of marketing the produce. And thus again rents fall. Any improvements that enable the same amount of produce to be raised from less land (*e.g.* improved rotation of crops), or that enable the same amount of land to raise the same supply at less marginal cost, have the same effects, namely, a fall in money rents. There are certain difficulties in working out the effects of improvements on rents which can only be surmounted by the aid of mathematics (see Marshall, *Principles*, Book VI, Chap. IX, note on Ricardo's theory of rent), but the general effect may be made clear by one consideration of a general character. Suppose that owing to improvements less capital is required on each portion of land to obtain the same produce, and suppose that the rate of profit remains the same. Since economic rent is the sum of the differential profits, if in

each case there is less capital, in each case also there is less profits, and the sum of the differences is less.

It is generally argued, as by Ricardo, that although the immediate effect is to lower rents, the *ultimate* effect of improvements will be to raise rents. The reason given is that there will be an increase of population which will again push out the margin so that in the end rents will rise beyond their former level. It is to be observed, however, that the increase of population is by no means so certain as was once supposed, and in old countries the growth of their population seems unlikely to counteract to any extent the improvements in transport as regards the great food staples. There may, however, be some compensating effects to the owners of the land by the use of the land for other purposes, which will be encouraged by the increase in the general wealth of the nation. Thus land becomes more valuable for its sporting rights, and for special forms of produce that will not bear the expense of transport or will suffer in quality.

The effects of agricultural improvements on rents, as worked out on the pure theory with an isolated country, generally seem paradoxical and somewhat unreal, even with the most careful explanation. It is, then, worth pointing out that we can obtain an exact illustration and, indeed, a confirmation of the theory if we consider the effects of *changes in the seasons*. A series of good seasons is exactly equivalent to a series of general improvements in production. The effect is still more noticeable if we take a period of good seasons after a period of lean years. It may be remarked that the popular idea that nineteen years (a complete cycle of the moon) is sufficient to give an

average of seasons is fallacious, and probably at least a hundred years would be required. Before the repeal of the Corn Laws, England was practically dependent on its own food supplies, and the determining factor in the price of corn was the course of the seasons. It was a matter of common knowledge that with a series of good years rents fell. From 1715 to 1765 there was a marked exemption of seasons of scarcity as compared with the fifty years before. As a consequence, provisions were cheap and abundant, and the general condition of the people was greatly improved. But we read at the same time of great agricultural distress which really meant a fall in rents. Indeed, many of the pamphlets of the time, in accordance with the ideas then dominant, tried to show that this fall in rents was a national calamity, "since the flourishing condition of the landed interest supports all trade." Exactly the opposite was witnessed in the great war.[1]

[1] This chapter is much abbreviated from *Principles*, Book IV, Chap. V. For the historical treatment, see Cunningham, *Growth of English Industry and Commerce;* Ashley, *Economic History;* Seebohm, *English Village Community;* and for the later periods, Porter's *Progress of the Nation* and Tooke's *History of Prices.* For the theory, Marshall, *Principles*, Book VI, Chap. IX; and for a simpler statement, Walker, *Land and its Rent.*

CHAPTER IV

PROGRESS AND PROFITS

1. General View. — A beginning may be made of this chapter as of the last by a brief reference to the growth of opinion. Mill arrives at the following conclusion as the result of his long investigation (by the abstract method) of the effects of progress on rents, wages, and profits: "The economical progress of a society constituted of landlords, capitalists, and labourers tends to the progressive enrichment of the landlord class, while the cost of the labourers' subsistence tends on the whole to increase, and profits to fall." It is allowed that for a time agricultural improvements may counteract the two last effects, and check the rise in rent; but it is supposed that the natural growth of population will soon transfer all the benefits to the landlords alone. How false this view is, as applied to agricultural rents, has been shown in the last chapter; and it needs no showing, if we look to modern conditions, that as compared with the owners of agricultural land it is the capitalists who have been enriched many times over. Even the owners of land in large cities cannot boast of such fortunes as the fortunes of modern trade. But, as already shown, the term *profits* is complex and covers very different forms of income that vary with different causes. The tendency of profits to a

minimum can only be retained as the title of a chapter of economic analysis.

It is difficult to form any adequate idea of the general rate of profits at different periods if the term is taken in an extended sense; but there is one important element in profits, namely, interest to which the historical method may be applied with some hope of success. "And the progress of loan-interest may lead us to form some notion of the progress of profit" (Adam Smith).

2. Progress and Loan-interest. — In modern economic theory we are accustomed to separate *pure* interest from interest combined with other elements, *e.g.* insurance against risk and wages for the trouble of managing investments, etc. We suppose that, given perfect security and negotiability, the rate of interest is uniform through the whole of a country and the whole range of investments. We say nothing of the nature of the security or the method of realisation of the principal or the interest. This conception of pure interest corresponds in the modern world to an important economic fact. This fact is, however, the result of a long process of evolution. The farther we go back the less do we find examples of pure interest or of uniformity of rates. We find rather all kinds of insecurity and all degrees of monopoly. The history of interest or usury is closely connected with the law of debt; the primitive form of security offered for a loan was the freedom of the borrower and that of his family. It is remarkable that with the lessening of the penalties for the non-payment of interest, on the whole the security for the payment has greatly increased. Also with the abandonment of the

severe penalties against usury, the abuses of usury have diminished. Probably one of the greatest gains of the nature of consumers' rents is the gain indicated by the fact that borrowers under modern conditions pay not in proportion to their needs, but at the market rate. The exceptions shown by recent abuses only prove the rule.

Another point to notice in the contrast of ancient and modern conditions is that the farther we go back the more were loans contracted in cases of necessity in times of famine or war. In the course of industrial progress, loans have been made more and more for productive purposes, and with similar security the same rate is charged for whatever object the loan is obtained. Even in ancient times, however, we have instances of loans for trading purposes, as in the case of Athens in connection with shipping.

As a consequence of the equalisation of interest in its various forms, on the whole its burden has decreased; there has been a levelling down and not up, as is only natural from the substitution of competition for monopoly. The development of the law of bankruptcy, and more recently of the principle of limited liability, has rendered lenders more cautious, and a check is imposed on the waste of capital. The increasing importance attached to public credit has given greater security for public loans.

The fall in the rate of interest from the early times in which high interest meant bad security, and the exploitation of necessity by monopoly, was no doubt a sign of progress; but it is doubtful once a certain stage has been

reached, whether a further fall in the rate of interest is a consequence or a sign of progress.

Loan-interest, as already explained, is also in sympathy with profit-interest, and there may be a rise in interest on account of the greater openings for industrial enterprise. In the reign of George II the net yield in the return to investments in the British funds was about the same as at present, namely, $2\frac{3}{4}$ per cent. In 1776, the year of the publication of the *Wealth of Nations*, the rate of interest in Scotland on first-class mortgages was the same as at the end of the nineteenth century, namely, 3 per cent, and the present (1903) rate is $\frac{1}{4}$ per cent higher. But it is plain that both England and Scotland have advanced on all the lines of economic progress since the eighteenth century.

3. Progress and General Profits. — When we pass from the comparatively simple case of interest, it becomes still more difficult to discover any necessary connection between the rate of general profits and the rate of economic progress. Although, as in the case of wages, it is also useful for some purposes to use the conception of a general rate of profits, and to quote this rate as a percentage of the capital, it must be remembered that profit per cent per annum is only a mode of estimating the actual profit derived from the turnover of the capital. (See Marshall's *Principles*, Book VI, Chap. VIII.) The capital value of any business, at any particular moment of time is the sum total of its assets less its liabilities, and the differences between any two dates is the gross profit over the period. How much of this gross profit is put down as interest or as insurance (*e.g.* as in the creation of a reserve fund), or

as wages of management, will depend on the custom of the trade, and for the purposes of theory there is, besides, the conception of *quasi*-rent.

The connection between profits and prices is not only fundamental in practice, but in a very true sense is also fundamental in theory. Changes in the general levels of prices, or in the exchange value of money, apart from the disturbances to which they give rise in the period of transition, do not affect profits, as Mill so laboriously explains. But in the course of progress, profits depend more and more on exchanges, and exchanges are expressed in terms of prices.

When once a society has passed from a natural to a money economy, the monetary valuation of capital (and thus also that of profits) is no longer a secondary, or accidental, but a primary quality.

What Mill calls the incident of exchange becomes in fact an essential part of the substance of capital. This historical fact had been thoroughly grasped by Adam Smith in regard to circulating capital. Circulating capital is that which affords a revenue by changing hands. The revenue or profit arises solely from a continuous oscillation of exchanges between money and goods, goods and money. The capital continues its existence by retaining its money valuation; anything beyond is profit and may be lopped off as revenue; anything below so far shortens its life, unless the defect is made up from future profit.

With fixed capital, "which yields a revenue without changing masters" at first sight, this character of exchange seems excluded from Adam Smith's conception.

Thus to take his example of seed corn: "Though it goes backward and forward between the ground and the granary, it never changes masters, and therefore does not properly circulate. The farmer makes his profit not by its sale, but by its increase."

It is easy to show, however, that even in agriculture the money valuation is essential to fixed capital. Recently many English farmers went on growing wheat with falling prices; but though the seed was returned sevenfold as before, the profit became less and the capital dwindled.

Similarly as regards buildings, machinery, and the like: they may be kept in good repair, and worn-out parts may be continuously replaced; but whether or not this part of capital has suffered real depreciation, depends also on the competition of other agents of production affecting the prices, and also on the sales of the product. Machinery that can only make unsaleable goods has logically lost its value as capital as effectually as if it had been corrupted by rust or destroyed by rioters.[1]

[1] It is worth noting that Adam Smith's position on fixed capital is still that which is applied in the Income Tax assessments and in the Companies Acts. The theory in both Company and Income Tax law seems to be that fixed capital has not to be replaced before profits are arrived at. The only notable exception is that an allowance may be made in Income Tax returns for the wear and tear of machinery and plant during the year; none, however, may be made for depreciation of value.

According to the Companies Acts profits are the excess of earnings over disbursements without any deduction for loss of capital.

As regards economic theory, however, it may be pointed out that the Income Tax law is full of anomalies and inconsistencies; and in practice, if a shareholder in a company receives larger dividends from "wasting" subjects, he must, to keep his capital intact, himself set aside a sum for depreciation.

4. The Tendency of Profits to a Minimum. — "To popular apprehension," says Mill (*Principles*, Book II. Chap. XVI, Sec. 6), "it seems as if the profits of business depended upon prices;" and later on in dealing with the tendency of profits to a minimum (*Principles*, Book IV, Chap. IV, Sec. 1) he controverts Adam Smith's argument on the inter-connection of profits and prices. But as is so often the case with Mill's paradoxes, Adam Smith and popular opinion express a great truth which Mill conceals with refinements of language. Profit, argues Mill, arises not from the incident of exchange, but from the productive power of labour.

But under a monetary economy all profits depend upon differences in relative prices, and the number of prices of sufficient magnitude to affect the margin of profits in any particular business is very great. The price of the labour directly employed is not always of predominant importance. Since, moreover, all prices depend upon demand as well as on supply, any account of profit which refers only to the productive power of labour omits the principal and most difficult parts of the problem. Even from the point of view of production in the narrowest sense of the term, the exposition is incomplete: capital in this sense has also productive power; machinery may be substituted for labour and may be auxiliary to labour; and if wages are ascribed to the productive power of labour, profits may with equal justice be assigned to the productive power of capital.

Productive power, however, with the widest interpretation, cannot extend beyond supply, and both wages and profits in societies resting on exchange must depend equally on demand.

Money wages and profits are both cases of relative

prices. Considered from this point of view, there is, indeed, one sense in which the tendency of profits to fall with the progress of society may be affirmed as a general proposition — and that is in the sense plainly indicated by Adam Smith. So far as profits depend on buying to sell again, the increase of competition tends to diminish the differences between the buying and selling prices. In general, competition prices are lower than monopoly prices. This argument applies also to the difference between the price of labour and the sale of its product; the profits of interchange fall as the difference diminishes, and either the labourer or the consumer must reap the benefit. If, then, as is the case in modern industrial societies, the great body of labourers is the same as the great body of consumers, we may say that real wages rise at the expense of profits.

As already explained, however, profits is complex, and a large part is itself wages. It is quite possible that the wages of management per unit of time may rise continuously compared with other kinds of time wages, whilst profits on the turnover of capital are continuously diminished. Men more often become millionnaires by handling large capitals with small differences than by handling small capitals with large differences.

The wages of management of large capitals is *per unit of time* by far the highest of all wages. So high, indeed, is the reward that the term *wages* seems altogether inapplicable in many cases, and *quasi*-rent is more suggestive of the fabulous riches involved.

Similarly as regards the third element in gross profits, namely, insurance against risk. In the course of progress

the sphere of insurance extends, and so far the element of risk is extruded from gross profits. The mediæval ship-owner had to take the risk of all kinds of perils, the insurance against which is now as much a part of cost as the safety valves in the boiler or the water-tight compartments.

But the maxim still holds good that the greater the risk to the individual, the greater the profit. The organisation of modern markets affords the possibility of immense gains, provided the speculator risks everything. Risk of this kind, however, is the risk of speculation, and obviously does not admit of insurance.

But speculation may mean anything, from reckless, ignorant gambling, in which one man's gain is another man's loss, to far-seeing calculations of the course of progress in all its departments. Speculation of this second kind sometimes deserves to rank with the highest efforts of practical genius, for without it such efforts never gain an opportunity for realisation. Occasionally, however, even *bona fide* and well-founded speculation obtains an extravagant reward as the result of good fortune; but such occasional rewards encourage the highest forms of enterprise, and fortune can only be seized in industry or in war by daring. "What a force it is! It alone imparts courage. It is the feeling that fortune is with us that gives us the hardihood to dare. Not to dare is to do nothing of moment, and one never dares except in the confidence that fortune will favour us" (Napoleon). It is, however, useless to attempt to strike an average in cases of this kind.

On the whole, the conclusion is that if the expression, *general rate of profits* is still retained in its widest sig-

nificance, the effects of progress on this general rate must be said to be indeterminate.[1]

[1] See *Principles*, Book IV, Chap. VI. In this summary the historical matter has been omitted, but the last section has been reproduced almost in full. The critical note on the connection between prices and profits has been omitted.

On the history of loan-interest, see Ashley's *Economic History*, Vol. I, Part 2, and Cunningham's *Usury;* on the general theory, Smart's translation of Boehm-Bawerk on *Capital and Interest;* Marshall, *Principles*, Book VI.

CHAPTER V

PROGRESS AND WAGES

1. Progress and the Price of Labour. — In considering the effects of progress on wages, wages may in the first place be regarded as the price of labour. The price of labour is of course only one element in the well-being of labour; but it is a very important element, and changes in the price of labour are associated with the principal features of economic progress. As already explained, the price of labour may be quoted, broadly speaking, in two ways, namely, per unit of work done or per unit of time. The two methods are closely connected, as it is always understood that so much must be done in the *day's* work, and that any piece of work must be done within certain limits of time. For historical purposes the unit taken is in most cases the day, and rates of piece-work can in the common forms of labour be reduced to this standard. The rate per day is, however, a fallacious test of earnings unless allowances are made for regularity of employment (and conversely). In estimating real wages there are as explained above (Book II, Chap. VI) other elements to be taken account of besides the money earned and what the money will purchase. But a comparison of money earnings with the chief articles of workmen's budgets must generally be the foundation of estimates of variations in real wages.

Exception, however, must be made to the common practice of taking as representative of labour only the lowest or most badly paid forms of labour. Such estimates are no doubt both interesting and important. But if real wages are interpreted in terms of pecks of wheat, and labour is interpreted to mean the lowest class of agricultural labour, such estimates cover only a small part of the field of economic progress.

Estimated in this way the progress of the working classes has been by no means continuous — taking for example the history of English labour during the last six centuries — and there might even appear to be some justification for the idea that the golden age of English labour was in the fifteenth century. But in estimating the economic progress of the labouring classes, perhaps the most important point of all to determine is the increasing *differentiation* of labour, and the increase proportionately in the higher grades as compared with the lowest.

This differentiation of labour is well shown by the variations in prices for different forms of labour. If we allow for the differences in the net advantages of the employments, it is the difference in the money wages which is the determining force in the distribution of labour in the different occupations. A new industry in order to attract labour must offer higher wages, and in the course of progress the changes in the occupations of the people may be accounted for by the cumulative effects of differences in the rates of remuneration which they offer.

It is probable that in the fourteenth century in England and Wales the number of males employed in agriculture

was no greater than the number so employed at present. But whilst in the former period the great bulk of the working population was dependent on agriculture, and women worked nearly as much as men, at present of the total number of male workers less than 12 per cent are in agriculture, and practically no women, thus leaving the bulk of the people employed in other industries. For centuries there has been a constant stream of labour flowing from the country to the towns, and the present diversity in English industries may be partly accounted for by differences in wages in the mediæval period.

The result of a general survey of agricultural and artisan wages is that the latter have always exceeded the former. In England, up to the end of the eighteenth century (downward from the thirteenth), the wages of the carpenter were in general 50 per cent higher; and during the nineteenth century they have become 100 per cent higher than those of the agricultural labourer. About the middle of the seventeenth century the wages of common unskilled labour in the towns began to exceed those of agriculture. It has often been observed that the wages in agriculture are highest in the neighbourhood of mining and manufacturing districts; and in general, wages in London have been higher than in the provincial towns in which the connection with agriculture is much closer. We find in these facts a proximate cause of the growth of the towns at the expense of the country, and of London and the larger cities at the expense of the towns. Labour tends to flow where the reward is highest.

The same facts as regards wages and occupations

also illustrate the difference between the statical and dynamical action of economic forces. In spite of the continuous migration of labour from the country to the town, the balance of money wages is still largely in favour of the town, nor can the difference be explained by the greater attractiveness of the country life; to the labourers themselves, now as ever, the pleasures and the freedom of the town seem greater than those of the country. These broad historical facts also show in a very realistic manner the nature of economic laws and tendencies; the tendency only indicates the direction of a movement in the absence of disturbing causes; it does not imply that even in the course of centuries a certain definite result will be attained. The tendency to the equalisation of the net advantages of different employments to equally efficient labour only indicates the resultant action of certain economic forces; it does not mean that in a long enough period such an equalisation will be attained.

Similar reasoning may be employed in dealing with the wages and the occupations of women and children. But in both cases a new factor is introduced: progress here may be estimated to a great extent by the contraction in the field of employment. It has been a gain to the nation at large, as well as to those most directly concerned, that women have been excluded by law from work in mines, etc., and by natural economic forces almost as effectively from agriculture. In the employments equally well adapted for women, progress has consisted in raising the rates of wages nearly to an equality with those of men for the same degrees of efficiency. When large numbers of women were employed in the same industries as men,

the tendency was for the men to gain the advantage in industrial competition; they were superior in physical strength and still more so in moral coercion. Thus women were gradually excluded from the more gainful occupations, and by the force of habit they came to be considered unwomanly. Until recently, though half the people in the world are females, there was still a prejudice against lady doctors; and though women are often litigants, they are rarely lawyers, even if the law permits. The exclusion of women from certain occupations increased the supply and thus lowered the wages in employments to which they were admitted. In recent years, however, the great natural economic forces have been working in favour of women. The growing wealth of the people has enabled a larger proportion of women to devote themselves to the duties of family life, and the lessened competition for the gainful employments has so far raised wages.

The employment of children, both as regards the amount of work and the kind of occupations, is one of the best signs of economic progress. Since 1891, in the United Kingdom, the employment of children under ten has been prohibited in most gainful occupations, and the employment of children of less tender years has been strictly regulated. In 1891 more than 80 per cent of the children of the United Kingdom under fifteen years of age were "unoccupied," which in most cases means that they were still being educated. The evils of the employment of children in the factories after the industrial revolution are now as well known and as heartily condemned as the horrors of the slave trade; but it is not so well known that in former times the employment of children in agriculture

and in the domestic industries was associated with grave abuses.

In a general view of economic progress the terms *labour* and *wages* ought to be taken in the widest sense; and account ought to be taken of the labour and the pay of those employed in the various professions and in the higher departments of industry. Here the chief point to notice is not only the rise in the average, but the enormous wages of the most successful. We observe the analogy with the differences in the relative prices of saleable "things." With the increase in wealth, scarcity values of all kinds may attain extravagant heights. The highest of all wages are the wages of management, if the term is extended so as to cover all the gross profit that is not set aside as pure interest and insurance.

2. The Relations of Labour and Capital. — Progress may also be considered from the point of view of the relations of labour and capital. This is a very large subject and can only be properly treated by detailed economic history. Here it must suffice to indicate that certain popular ideas on the subject are not well founded. It is often supposed that it is only in modern times, since the introduction of machinery on a large scale in all its forms, that capital has become stronger than labour, and that under simpler conditions labour was more independent and obtained a greater proportionate share in the combined product of labour and capital. The falsity of this view may be shown by a very simple consideration. In the pre-machinery age the greater part of the people were employed in agriculture, and the farther we go back the greater was the proportion. But as already shown, agricultural wages were always relatively

low. And if we look to the relations of labour and capital in this dominant industry, the relative superiority of capital was far greater than in modern large industries. Even after the effective abolition of serfdom the agricultural labourer was oppressed by the weight of custom and of law. In the reign of Elizabeth it was enacted that all single persons between twelve and sixty not having a visible livelihood "are compellable by the justices to go out to service in husbandry." The laws of settlement were almost as effective as villeinage in keeping the villagers to their own village; and as Adam Smith said of his own time, there was scarce a man of forty who had not suffered from this ill-contrived law.

Again, even in the towns it is false to suppose that every worker was an independent master as soon as he ceased to be an apprentice; the gilds only included the aristocracy of labour, and the misery of the labouring poor in the towns was probably greater in proportion the farther we go back.

Under the system of large industry and labour hired for wages there cannot be intimate personal relations; but there is no reason, in the nature of things, why there should not be good feeling and general interest in the success of the business. And experience shows that, as a rule, the more successful the business the better the relations of labour and capital. Mill supposed that the relations of master and workmen would be gradually superseded by partnership in one of two forms; namely, either profit-sharing or coöperation; but his forecast has been singularly untrue. Taking production in the popular and narrow sense of the term, as it was taken by Mill in this forecast, it may be said that the proportion conducted

on the lines of these industrial partnerships is so small as to be hardly worth considering. On the other hand, the opposing combinations of labour and capital, the trade unions and the associations of employers, have grown greatly in strength. It seems as if improvements in the relations of capital and labour are to be looked for partly in the development of arbitration and conciliation, and partly in legislation as regards the conditions of employment on the side of sanitation, etc.

Finally, it may be pointed out that no extension of the principle of association or combination to labour can displace altogether the principle of individual competition. There must always be industrial competition between the different processes in manufacture. The system of large industries does not mean that there are uniform rates of wages in each of these industries, or that in each a species of wages fund is equally distributed: there are in manufactures thousands of different rates, and they are determined in the last resort by competition and "the principle of substitution."[1]

[1] *Principles*, Book IV, Chap. VII, gives a good deal of historical matter condensed from the works of Rogers, Vicomte d'Avenel, Cunningham, etc.; for the early periods, Eden's *State of the Poor* is the standard work; for the nineteenth century the works of Mr. and Mrs. Webb on *Trade Unions* and *Industrial Democracy* are full and valuable on the industries with which they deal, but should be supplemented by special works, *e.g.* the official reports on Agricultural Wages by Mr. Wilson Fox; the wages of domestic servants by Miss Collet; see also Bowley, *Wages in the United Kingdom in the Nineteenth Century;* Palgrave, *Dictionary of Political Economy*, Art, "Wages"; Mayo Smith, *Statistics and Economics*.

BOOK V

THE ECONOMIC FUNCTIONS OF GOVERNMENT

CHAPTER I

ECONOMIC FUNCTIONS OF GOVERNMENT

1. The Principle of Natural Liberty, Laisser-faire, or "Minimum Interference." — Contrary to the popular view, Adam Smith did not set up the system of minimum interference as an economic ideal, and still less as the most general political ideal. At the very outset of his preliminary presentment of the "obvious and simple system of natural liberty," he introduces a most important qualifying clause. Every man is, indeed, on this system left perfectly free to pursue his own interest in his own way, but, mark the qualification, only "as long as he does not violate the laws of justice." Thus the freedom of competition of the industry and capital of individuals is always subject to the limitations of these avowedly higher laws of natural justice. And again, according to the system of natural liberty, the sovereign has — it is true — *only* three duties to attend to, but they are duties of the greatest importance, viz. protection against other states; the protection of every member of the society from the injustice or oppression of every other member of it; and, finally, the duty of erecting and maintaining certain public works and institutions which it can never be the interest of any individual, or small number of individuals, to erect and maintain. Thus, according to the actual teaching of Adam Smith, if competition leads to injustice or oppression, the

State ought to intervene; and if self-interest is inadequate to provide various institutions for the satisfaction of social needs, the State ought to provide for their erection and maintenance.

2. The Principle of Maximum Utility. — The system of maximum utility is a deduction from the general system of utilitarianism. On this view the *art* of political economy has for its object, briefly stated, the attainment of the maximum utility of which the society is capable by means of wealth. Accordingly, the government may interfere with the freedom of individuals in *production* if it can increase the aggregate of wealth; and it may interfere with their freedom in *distribution* if on the whole a greater amount of utility accrues to the members of the society.

The *prima facie* ground, says Sidgwick, for the interference of government with the distribution of produce is the great and ever increasing inequalities in income to which the individualistic organisation leads. The common sense of mankind, he asserts, holds these inequalities to be objectionable for reasons stated explicitly in two propositions laid down by Bentham.

These propositions are (1) that an increase of wealth is, speaking broadly and generally, productive of an increase of happiness to its possessor; and (2) that the resulting increase of happiness is not simply proportional to the increase of wealth, but stands in a continually decreasing ratio to it.

The *first* of these propositions may easily be reduced to a truism by those who identify utility with happiness; and the second proposition is simply a statement of the law of diminishing utility which has already been so fully

illustrated; a shilling to the man that is fasting would mean more happiness than to the man that is full.

The conclusion that is drawn from these innocent propositions is said to be obvious. "From the two propositions taken together the obvious conclusion is that the more any society approximates to equality in the distribution of wealth amongst its members, the greater, on the whole, is the aggregate of satisfaction which the society in question derives from the wealth that it possesses."

It would appear to follow that the State ought to use its power to correct the inequalities that spring from the selfishness of individuals, and to look to the maximum happiness of the whole society. And this indeed is the argument of those who advocate communism or socialism. But this simple solution fails even on utilitarian grounds. If the food and other produce to be distributed fell like manna from heaven, equality or inequality of distribution would not affect the supply of the food or of the mouths to eat it. It is not so, however, with economic utilities. Economic utilities are in general the result of labour and sacrifice, and in their case equality of distribution would, as Sidgwick shows, at the same time diminish the dividend and increase the divisor, and in the end the diminished quotient might give less than the aggregate happiness insured by the present system.

The inference drawn from the two Benthamite propositions is only legitimate under certain conditions, viz. "that the total amount of produce to be divided, and the number of persons among whom it is to be divided, remains unaffected by the change in distribution." And a third condition is added to the effect that the change has

no tendency to diminish the happiness of the community so far as it is derived from other sources than the increase of wealth, such, for example, as "culture," and the virtues which are fostered by the strivings of individuals under unequal conditions.

3. **Summary of the Benefits and Defects of Individualism.** — It is universally recognised that in *consumption* freedom is beneficial, and must, at any rate, be the general rule. It is true, to take the prominent examples, that there are laws against adulteration and laws regulating the consumption of liquor; but the whole of these laws affect the aggregate mass of consumption to a relatively small extent.

As regards *production*, freedom of enterprise and freedom in the selection of processes is still the rule, and *qua production* is recognised as beneficial. Every industry is constantly changing and the initiative is taken by individuals, and the survival of the fittest in productive processes is achieved by competition. Even when commercial competition is restrained by a trust, industrial competition survives within the ring. But when production is regarded, not from the point of view of the products, but from that of the *personality of the producers*, the case is by no means so simple. It is true that effective competition tends to increase the efficiency of labour, and one of the factors in efficiency is improvement in the conditions of work. On the whole, however, competition acts very imperfectly in securing the best conditions of production as affecting the health and morals of the workers, and regulation by the State has been extensively adopted with success.

As regards the *distribution of the national wealth*, the tendency of competition — if effective as regards the

mobility of the productive agents and the organisation of markets — is to proportion reward to the net value of the service rendered to the society. And in many cases inequalities of reward in this sense would be remedied by more effective competition. In fact, the main factor in the progress of distribution has been the substitution of freedom of contract for privilege and delegated or permitted authority. There are, however, many cases in which the conditions essential to freedom of contract do not prevail, and there are others in which freedom of contract passes into freedom of coercion.

Such is especially the case with associations which are instituted on a voluntary or contractual basis. Such associations easily attain powers which, relatively to individuals, give them an overpowering position; and a combination of associations may have similar power compared to any one. There are further relations assumed by associations towards the public which could never arise with individuals. One man is as nothing against the whole people; but one company, still more one gigantic trust, may revive in a new form the old right of private taxation. The predatory and parasitic tendencies of combinations are far stronger than those of individuals, just as a mob is more cruel than the average of its members. And altogether apart from abuses, the civil relations of associations to third parties are extremely complex. Accordingly, a large part of mercantile law is occupied with various economic combinations, *e.g.* partnerships, companies, unions, and associations, and with further development, further extension of the law may be necessary.

Thus when we take a dispassionate survey of individual-

ism, considered as the basis of modern industrial societies, we find it is open to criticism both in principle and in detail.

The two supports of the system are freedom and self-interest. But freedom is freedom under the law, and self-interest includes interest in others and in the State. Thus freedom is not merely absence of restraint or the negation of government. On the contrary, it may be said that the highest form of government is that which secures the highest form of liberty.

And self-interest may be so interpreted as to mean that higher self, which in every man is supposed to sit in judgement on the doings of his imperfect and misguided self. And again reason may counsel the suppression, by the power of law, of various forms of lower self-interest.

And in each of the great economic departments we find that abuses and failures may arise from unregulated individualism. In consumption, in production, and in distribution there are cases which seem *prima facie* to call for remedies on the part of the State.

4. The Methods of Legal Interference. — The methods of governmental interference may be divided into two great groups. *First*, the government may regulate the actions of individuals by providing and enforcing a system of *positive law;* and *secondly*, the government may itself perform certain economic functions.

Under the *first* group we observe: (*a*) the government may bring certain kinds of economic abuses — whether of omission or commission — under the *penal* law, and inflict punishments of various degrees of intensity upon the offender.

The simplicity of the method of regulation through the

criminal law has always made it attractive to legislators and reformers. This method, however, is subject in practice to very effective limitations. Just as the letter of the law varies with the ideas of its framers, so also does the enforcement vary with the ideas of its administrators. The greatest agency in the mitigation of criminal statutes in England has undoubtedly been the refusal of juries to convict, and of judges to inflict the penalties; the juries have turned a blind eye to the evidence, and the judges have given them the appearance of reason by legal fictions. It follows that the limits to the power of governmental action by the method of criminal legislation are found in the actual moral sense of the community; the ultimate sanction of the criminal law as regulating economic actions is found in public opinion. Thus, even as regards the obvious and simple system of coercion, the tendencies of the opposing system of natural liberty have to be considered.

(*b*) The government, without going the length of prohibiting or penalising certain actions, may *refuse to enforce* the corresponding *agreements* or promises of performance. In some cases this refusal rests on the legal incapacity of the persons to make the agreement binding.

The development of mercantile law is a good illustration of differences in legal capacity. At first merchants were a special class having special privileges and subject to special duties, and the mercantile law so far as it existed was administered in special courts (*e.g.* the Staple and Piepoudre); in the second period the mercantile law consisted of a body of customs which must be proved as facts, and were binding only upon the special class of mer-

chants; in the third period these customs were incorporated in the general law and made binding on all, whether merchants or not (Smith's *Mercantile Law*).

It may be observed that the tendency of legislation in progressive societies has been to abolish the special rights and duties of special classes as regards making and enforcing contracts.

(*a*) The government may make certain requirements of *form* essential to the enforcement of certain contracts. The contrast between ancient and modern conceptions of contracts as giving rights of action is remarkable and instructive. "According to the modern conception of contract, all agreements which satisfy certain conditions of a general kind are valid contracts and may be sued upon in the absence of any special legislation forbidding particular contracts to be made, or denying validity to them unless made with particular forms" (Pollock). Ancient law, on the other hand, regards only formal contracts. "The fundamental assumption of ancient law (when it has got so far as to recognise contract at all) is that the validity of a contract depends, not upon the substance of the transaction, but upon its form. The rule is that formal contracts only can be sued upon; the want of any part of the formalities is fatal; the fulfilment of them is conclusive" (Maine).

No better instance could be given of the extension of the liberty of individuals or the diminution of the sphere of state control. In modern times the enforcement of particular forms is generally either for the purposes of revenue, as in the stamp duties, or of registration — the ultimate object being not restriction, but publicity. The

form as such is of no importance; the decisive consideration is the intention of the parties, or the intention of the State.

(*d*) The government may, however, make *compulsory in contracts certain requirements*, not only of form but *of substance*. In no *contract*, whether dealing with land or any other subject-matter, do the parties express *in extenso* all the rights and obligations involved. Certain provisions are held to be applied by the law, general or special. It may be observed, however, that save in specially excepted cases persons are at liberty to contract themselves out of the particular obligations imposed (otherwise) by statute. And a law which admits of "contracting out" generally remains a counsel of perfection, or at best provides a legal interpretation in case of need.

The cases, however, in which evasion of this kind is not permitted, are in modern States both numerous and important. In the contracts in use in most great industries — in agriculture, mining, manufactures, fisheries, railways, navigation — the legislature has made certain clauses compulsory, and has prohibited the insertion of others.

This method of interference also has its limitations. If the government attempts too much, having regard to the ideas, customs, or prejudices of the times, either by way of compulsion or prohibition, the law is either evaded by the parties affected or nullified by its administrators.

5. **The Methods of Governmental Action.** — (*a*) The government may itself assume the position of a *monopolist* as regards certain industries or economic services. This case differs from that first noticed, namely, regulation by penalties, in that government not only prohibits others,

but itself performs. The freedom of the individual is equally restricted, but the government takes away the real burden of restriction by itself satisfying the economic want. Thus the post-office has a monopoly of letter-carrying, but most people look on this monopoly as advantageous. Again, the government prohibits private coinage, and again also confers a benefit by the prohibition.

The assumption of monopolies by governments (with the exceptions noted), and still more the delegation of such powers by patents to individuals, has in the course of time been greatly diminished.

(*b*) The government may *undertake* certain kinds of *business*, but at the same time *allow private enterprise* to compete, as, for example, in providing for religious services, or for the conveyance of parcels. In this case — that of governmental management side by side with private enterprise — the only element of compulsion consists in the coercive levying by taxation (as in church tithes) of the funds required for carrying on the business, and when the business can be made to pay its own expenses (as with the parcel post) even this element of coercion vanishes. In forming an estimate of cost, however, it is important to take into account all the indirect expenses and supplementary charges.

(*c*) The government may intervene simply to carry out the *wishes* of the *parties concerned* (as, for example, in providing official arbitration). A great part of the law of every State is intended simply to provide, or enforce, settled rules, *e.g.* the rule of the road on land or sea. What the rule is, is often a matter of indifference, provided only it is fixed and known.

The principle of the law of inheritance (when freedom of bequest is allowed) is in case of intestacy to carry out the supposed wishes of the deceased.

The laws of bankruptcy are in some respects similar to the laws of compulsory inheritance. The bankrupt is so far civilly dead, and the State lays down the rules for distribution of his estate amongst the creditors. If it be supposed that the creditors wish for a just distribution, the State only carries out their wishes.

(*d*) The government may provide for the *erection* and *maintenance of various public works and institutions*, for the provision of which private enterprise is unequal. This is the case which was dealt with very fully by Adam Smith, and in our own time is being pushed to an extreme by socialists. It is a very large case, especially in the guise of municipal trading and poor relief. The limitations to governmental and municipal work of this kind are found partly in the limits to taxation or other sources of revenue, — if the works and institutions are not self-supporting, — and partly in the limits to public expenditure which must conform to certain general principles. (See Chapter VIII.)

Before considering the degree and nature of the limits imposed by public finance, it is necessary to notice briefly certain limitations of a general character, which are applicable to all kinds of governmental control.

6. General Limitations to Governmental Interference. — With the best intentions, governments may ruin their legislation by ignorance and their administration by feebleness. The government, even of the most democratic states, must be formed of persons who are themselves liable to errors of judgement and errors of passion. And to a

considerable extent they are supposed to carry out the mandate of their electors. The electors are open to all kinds of persuasion, as well as to the persuasion of justice and reason. In the most advanced democracies, laws are still made and unmade in the interests of powerful classes, and sometimes against the interests of considerable minorities. Officials are still appointed for all sorts of reasons apart from merit and efficiency, and are removed, or not removed, on a similar diversity of excuses. The one and sufficient explanation of these shortcomings is, that government is carried on by men, and all men are imperfect.

Governmental interference is always in danger of one horn of a dilemma. If the individual official is left free to exercise his own judgement, there is the danger of caprice or jobbery, or simple foolishness; if his freedom is curtailed, he must act by routine, and routine is not adapted to the ever changing conditions of modern societies.

Another limitation in lawmaking is found in the *endurance* of the laws. Laws are now generally held to continue in force until they are definitely repealed. Thus, a law passed under popular excitement caused by temporary circumstances may become a nuisance before it has well got into operation. If the endurance of laws has its advantages — if every generation of reformers can only hope to provide the necessary marginal increments — it has its disadvantages, especially in progressive societies.

If a law is passed, or the government otherwise interferes in favour of one set of persons, it must be prepared by the principle of *formal justice* or uniformity to extend similar action to all similar cases. As far as the letter of the law permits the courts will make the extension; and justice

goes beyond the letter of the law. Hence the danger of creating precedents. The most effective limit to public expenditure and to the assumption of new duties by the State, is the knowledge on the part of the government that they must be prepared to apply the same principle to all similar cases.

Every *increase in the power of government* and every extension of governmental interference increases the *possibility of abuses*. Appointments may be given or withdrawn, not on account of fitness or incapacity, but for services to a political party. Power granted for one purpose may be misdirected to other purposes in the interest of the dominant political class; for even with the most effective representative systems the cabinet has very great power. There may be wasteful expenditure under the influence of popular sentiment; the machinery of government may be overburdened with work, and with the nicest adjustment of delegated authority some central control is always necessary. The self-interest of officials may be opposed to the interests of the public, and reward by honours and promotion depends for its effectiveness on the wisdom of selection.

The authoritative prohibition of any course of conduct so far involves a limitation of freedom, and it may well happen that there will be no corresponding extension of freedom in other directions. On the principle of utility, the loss of freedom may too readily be held to be compensated by a gain of happiness in something else and by somebody else. But the loss of freedom tends to starve the development of character, and in the words of Mill, unless the conscience of the individual goes freely with the

legal restraint, it partakes either in a great or in a small degree of the degradation of slavery.

It is sometimes supposed that a government of the people by the people or their representatives is altogether different from a despotism; and that under what is called a free government every individual must be free. This vague language will not bear analysis,[1] and the idea which it is supposed to express has been forcibly exposed by Mill. "It is no less important in a democratic than in any other government that all tendency on the part of public authorities to stretch their interference and assume a power of any sort that can readily be dispensed with should be regarded with unremitting jealousy. Perhaps this is even more important in a democracy than in any other form of political society; because where public opinion is sovereign, an individual who is oppressed by the sovereign does not, as in most other states of things, find a rival power to which he can appeal for relief or at all events for sympathy." And again: "In some countries the dream of the people is for not being tyrannised over, but in others it is merely for an equal chance to everybody of tyrannising. Unhappily, this last state of the desires is fully as natural to mankind as the former, and in many of the conditions even of civilised humanity is far more largely exemplified." [2]

[1] "That the condition of a slave is better under an arbitrary than under a free government is, I believe, supported by the history of all ages and nations." — ADAM SMITH, p. 264.

[2] This chapter is greatly abbreviated from Book V, Chaps. I–IV, in the *Principles*. See Sidgwick, *Political Economy*, Book III; *Elements of Politics*, Chap. IV; Mill, *Political Economy*, Book V, Chap. XI; *Wealth of Nations*, Book V; Bosanquet, *Philosophical Theory of the State*, Chap. VI.

CHAPTER II

CHARACTER AND DEFINITION OF TAXATION

1. The General Characteristics of Taxation. — (*a*) The principles of taxation are well adapted for the application of the historical method. Instead of deriving the modern conception of taxation from the modern conception of sovereignty, we may trace the historical evolution of the principal characteristics. As in other cases, the continuity and variety of English economic history may be trusted to furnish evidence of the principal stages. The most general feature of taxation, that marks it off plainly from other payments (in money, kind, or services), is that the payment is *compulsory*. A tax is an exaction levied by superior force; it is not the result of charity, persuasion, request, or contract, although these names and sometimes the ideas which they stand for have been used to disguise or modify the original compulsion.

Too much is made of the names assumed by early forms of taxes — the "gentle terms" *donum* and *auxilium*. There were, indeed, at times a few "gifts" in answer to the "prayers" of the king; but the prayers were in general of the *quibus non contradici* order, and the gifts were like the "precarious" services of servile tenants, or the boon works at the prayer of the lord (*ad precem*), which Seebohm regards as the most distinctive mark of subjection.

The most noteworthy characteristic of mediæval taxes

is that, levied first as proportionate and variable rates, they became fixed and customary — as in the case of the tenths and fifteenths, which came to mean a certain aggregate sum.

The principal modifications in this element of compulsion are found in the gradual transfer of the compelling right to the House of Commons, and it may truly be said that the more effective the representation so much the more effective became the compulsion.

(*b*) The compulsion of taxation is, however, really modified when *evasion* is wholly or partially possible. That a tax that can be evaded will be evaded may be illustrated to the extent of an inductive proof. The evasion may, as Professor Seligman remarks, be illegitimate, as in smuggling or false declarations of income, or legitimate, as when the taxed commodity or process or service is avoided. Evasion in the first case is met by various penalties and preventions, and for scientific purposes an evaded tax of this kind is no tax.

Evasion of the second kind, however, is not so complete. It is sometimes said that a tax upon commodities is voluntary, because the consumers may refrain from consumption or resort to other things. Leaving aside the impracticable remedy of the taxation of all possible substitutes, taxes of this kind have always an element of compulsion. It is true that a man may escape the tobacco duty by not smoking (as, indeed, he may escape the income tax by not earning sufficient income), but his natural or acquired inclination to smoke is (as shown by the revenue) sufficient to outweigh the pleasure of evasion.

The legitimate evasion of taxes on productive processes in some cases leads to improvements and inventions, but in general the necessities of fiscal supervision by stereotyping old methods prevent natural progress. The necessity of taxation is only the stepmother of invention.

(*c*) The objects for which taxes are imposed are coextensive with the objects of public expenditure.

In the course of progress we find that special taxation for special purposes has given way to general taxation for general purposes. The method of assigning particular revenues for particular expenses (*e.g.* the aids for making the king's son a knight, or marrying his eldest daughter) has generally fallen into decay, although it still survives in local taxation, and there are occasional reversions to this older method. Even in local taxation, however, it has come to be recognised that special rates for special services are, in many ways, uneconomical (*e.g.* separate rates for schools, poor, roads, police, etc.).

(*d*) Payments, however, may be made to government which are only partially of the nature of taxes. Such, for example, are the *prices* paid by the consumers of commodities sold by the State, and *fees* for services rendered. If the State has a monopoly and fixes prices or fees above what would be the case with natural competition, the extra price or fee is of the nature of a tax. If the State competes with other agencies and charges only competitive rates, this element of direct taxation vanishes. If, as is often the case, the State charges less than cost price (including supplementary costs), the deficit must be met by other taxes, and itself is of the nature of a bounty on consumption.

(*e*) In modern times the revenues of the State that imitate most nearly voluntary contributions for the public services are those derived from public loans. To meet extraordinary expenditure (as in war) a loan is contracted, and subscription to the loan is voluntary. The element of compulsion, however, is only transferred from the present to the future taxpayer. Interest and principal can only be paid out of future taxes.

(*f*) Taxes are nominally imposed upon various forms of wealth in the widest sense, but all taxation is really imposed on *persons*. This proposition is derivative from the general conception of wealth. One of the essential marks of wealth is appropriation, and taxation is a process of transferring wealth from private individuals to the state. Every public tax diminishes so far the wealth of private individuals. It is of course true that in most cases there is some set-off to the disutility of taxation in the utility of the government, and the utility may exceed the disutility even to the particular payer. Occasionally, also, the imposition of a tax may indirectly benefit certain persons, as in the typical case of protective duties.

It is, however, in a general survey, best to look on taxation as involving in itself a contribution on the part of persons on the compulsion of the State, and to consider separately the benefits of public expenditure, and also the economic, constitutional, and other limitations imposed on the exercise of this compelling power.

Professor Bastable's definition of taxation sums up in a convenient form the principal results of the foregoing analyses, "A tax is a *compulsory* contribution of the wealth of a *person*, or body of persons, for the *services* of

the *public powers*." If the State is already the owner of all the forms of wealth that it requires, no taxation is necessary; if it requires more wealth, it must make it (industrial domain), or take it (taxation).

It may be observed that what is first imposed as a tax tends to become in some cases a form of state ownership. A land tax regarded as perpetual becomes a rent charge owned by the State. Thus the expression that an old tax is no tax really means, in this case, that taxation has been merged in state ownership. The real incidence of the original tax is upon the original owner; at the imposition of the tax the value of his property is diminished by the capital value of the tax.

CHAPTER III

THE CANONS OF TAXATION

1. Adam Smith's Canons of Taxation: First, Equality. — The treatment of the general principles of taxation may well begin with a critical analysis of Adam Smith's celebrated canons. The first canon, *Equality of Taxation*, stated in full, is found to contain the germs of several distinct theories of what constitutes equal or just or equitable taxation.

"The subjects of every State ought to contribute toward the support of its government, as nearly as possible in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the State. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation. Every tax, it must be observed once for all, which falls finally upon one only of the three sorts of revenue above mentioned (viz. rent, wages, profits) is necessarily unequal so far as it does not affect the other two. In the following examination of different taxes I shall seldom take much further notice of this sort of inequality, but shall in most cases confine my observations to

that inequality which is exercised by a particular tax falling unequally upon that particular sort of private revenue which is affected by it."

To begin with, the use of the phrase "the subjects ought" implies that it is the duty of the subject to contribute, and the right of the sovereign to impose, taxes. Thus the right of taxation may be derived directly from the conception of sovereignty — which brings to view the *compulsory* character of the contribution.

This doctrine of sovereignty as the basis of taxation finds important illustrations in history. Taxes have been imposed, not for the value of the real revenue they may bring in, nor from any idea of public advantage, nor even for the private advantage of the monarch or other persons in authority, but simply to show to the subjects the right of the sovereign. It was the determination to insist on this barren and malignant sovereign right which led to the retention by the British government of the threepence per pound duty on tea, "that figment of a tax, that peppercorn rent," and of the stamp duties that never paid the cost of collection — "shearing the wolf" — that lost the British the American colonies.

It is not often, however, especially in modern times, that the pure and simple doctrine of sovereignty is considered sufficient authority for taxation. The Americans (and on their side were some of the greatest of English statesmen) opposed to this absolute doctrine the great constitutional rule, that taxation ought to be coincident with *representation* — that only those who shared in the power should be called on to bear the burdens of government, a position heartily approved of by Adam Smith, and made

by him the basis of his great scheme of imperial federation.

The whole course of constitutional history is marked by the struggle of the payers of taxes for the control of taxation. And taking a general view, it may be said that the burden of taxation tends to fall most lightly on those who have the greatest political power.

The doctrine of sovereignty as the basis of taxation, logically carried out, results in the maxim that a government should impose such taxes as are "most easily assessed and collected" (McCulloch). Just as a general looks to the efficiency of his army as a whole, and is prepared to sacrifice any portion if necessary, so it may be said that the State should not regard the particular interests of individuals, but rather consider the power of the State as a whole and what is most conducive to that power. In times of national peril, when the political existence of the State is concerned, this view seems to meet with general acquiescence. But in ordinary times in the modern State, such a complete sacrifice of the individual is never contemplated, and the sovereign power in taxation is supposed, even on McCulloch's view, to be used in the way "most conducive to the public interests." And since one of the primary public needs is the equitable treatment of individuals, we advance from the general proposition that the subjects ought to contribute to the support of the government, to the important qualification, that they should do so "as nearly as possible in proportion to their respective *abilities*." Adam Smith goes on to explain, that the measure of abilities, in his view, is the revenue enjoyed under the protection of the State, and thus the nat-

ural result of his first canon is that taxation should be proportionate to revenue. But this simple interpretation has not always been accepted.

2. Equality of Sacrifice.[1] — The critical examination of the term *abilities* discloses two very different bases of taxation, which may be described provisionally as *subjective* and *objective*, according as stress is laid on the *inconvenience* or *disutility* involved in the payment of taxes on the one side, or, on the other, on the *ability* or *faculty* of the taxpayer as indicated by his property or income. The development of the subjective basis of taxation leads to the principle of *equality* of *sacrifice*. "Equality of taxation," says Mill, "as a maxim of politics, means apportioning the contribution of each person toward the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his." Mill points out that this standard, like other standards of perfection, cannot be completely realised, but it is put forward as the principal ground of various practical modifications of systems of taxation.

In the first place it may be urged that if taxation in the case of A leads to a sacrifice of "necessaries," whilst in that of B the sacrifice is only of "superfluities" or "luxuries," the burden of A is infinitely greater. And since we can never establish equality between the infinite and the

[1] Cf. Edgeworth, "Pure Taxation," Part III, *Economic Journal*, December, 1897, for a very able and learned discussion of the sacrifice theory of taxation on utilitarian principles. He prefers to state the ideal as "minimum" sacrifice instead of equal, and this statement seems the more logical on the pure utilitarian theory. On grounds of formal justice the equality of sacrifice may be preferred.

finite, it follows as a practical maxim that the necessary minimum of income must be exempt altogether.

This principle of a free minimum income has been partially applied in the United Kingdom: *first*, in the abolition of most taxes on such necessaries as food, clothing, fuel; and *secondly*, in the exemption from direct taxes of incomes below a certain minimum and also of savings in the shape of insurance. But as regards indirect taxation in general, it may be said that a considerable part of the revenue from stimulants (alcohol, tobacco, and tea) is derived from persons whose incomes are below what is generally considered a reasonable minimum for the standard of comfort; and the same thing is true of some forms of direct taxes, *e.g.* various local rates.

And however plausible the doctrine of a free minimum income may appear, it is always limited by the great practical rule that taxes must be productive.

The principle of equality of sacrifice is also advanced in support of graduated, or progressive, taxation. And at first sight — having regard to the law of diminishing utility — equality of sacrifice seems necessarily to lead to progression. We may suppose that the more money any person has (whether as capital or income) the less is the utility to him of successive increments, and therefore the less the disutilities of decrements caused by taxation. It seems to follow that a greater amount should be taken from the relatively rich, and that a merely equal percentage would not involve equal real sacrifice.

It is, however, one thing to admit that equal percentages do not involve equal real sacrifices, and quite another to formulate any rational scheme of progression *merely* on

the theory of *utility* and disutility. "The economic calculus is not at present competent to deal with such comparisons (*e.g.* the real sacrifices involved in the taxation of different incomes). The weightiest difficulty that the theoretical advocates of progression have to meet is the essentially subjective nature of their standard. The translation into an objective rule of taxation can only be accomplished by the aid of assumptions as to the relations of enjoyment in different classes that must contain a large element of conjecture. The modern developments of the theory of utility fail to supply any definite practical basis on which to frame a scale of progression" (Bastable).

The opinion of Professor Seligman to the same effect is also worthy of citation, especially as on *other* general grounds he is inclined to support the principle of progression. "The imposition of equal sacrifices on all taxpayers must always remain an ideal impossible of actual realisation. Sacrifice denotes something psychical, something psychological. A tax takes away commodities which are something material, something tangible. The sacrifice occasioned by a tax is only one factor in the problem, and may be a minor factor."

It is alleged that a tax on income ought to vary according to the *source* of the income — that, in particular, incomes from realised wealth, *e.g.* land, should be taxed at a higher rate than incomes from talent, and professional and business capacity — or more generally, that terminable incomes should be taxed at a lower rate than perpetual incomes. In its practical form this discrimination is justified on the particular ground that the professional man is obliged to put aside, by way of insurance for himself

or his family, a larger proportion of his terminable income. Thus there is a smaller free income from which to pay the tax, and consequently a greater sacrifice. It may be observed that in the English income tax exemptions on the ground of insurance were reintroduced by Mr. Gladstone in 1853, and have since been continued.

The exemption of a part of the income saved for insurance shows very well the difficulties of discrimination. This exemption discriminates between forms of investing savings in favour of one; if a man invests part of his income in higher education for his children, or in buying his house or farm by instalments, or in any of the multitude of other indirect modes of providing for the objects of insurance, he has logically an equal claim to exemption, but practically he obtains none.

3. The Faculty Theory of Taxation. — The development on the *objective* side of Adam Smith's position, that the subjects ought to contribute in proportion to their *abilities*, leads to the *faculty* theory. "The faculty theory of taxation is very old. The word *faculty* is the usual one in Latin and French for tax laws, and is the general term employed in all the early American laws. For a long time, however, the best practical test of faculty was supposed to be general property. Thus all through the Middle Ages, when local taxes were levied at all, they were assessed on general property, on the principle *juxta bonorum facultatem*, or *pro bonorum facultate*" (Seligman). In England the word *ability* is first used in a general statute in the Elizabethan poor law, — "according to the *ability* of the parish," — ability being interpreted to mean property. Later on, from meaning property, ability or

faculty came to mean income, and Adam Smith explains abilities to mean revenues.

The great merit of the faculty theory is that it substitutes an objective for a subjective standard. It does not look to the feelings of the taxpayer, but to the money value of his taxable capacity. The State takes more from the rich, not because they will feel it less in proportion, but because they have more to give.

But although the faculty standard is objective, it does not follow that it is simple, and what is the proper measure of faculty is still a subject of dispute both in theory and in practice. Historically the rule of simple proportion has been generally adopted. But it is worth observing that this rule was first of all insisted on in order that the property of various privileged classes should not be exempt. That subjects should contribute in proportion to their revenues was directed against the privileges of the nobility, clergy, and other favoured classes.

In course of time, however, the method of simple proportion has been attacked with reference to both extremes of the social scale.

In the first place it has been maintained that the minimum of subsistence ought to be exempted, not as before, on account of the infinite sacrifice involved, but on purely economic grounds.

Taxation which diminishes the general efficiency of labour diminishes the whole faculty of the State, and is thereby on the simple faculty theory suicidal.

A similar argument may be applied to capital and profits. Taxation which prevents productive capital from being restored and renewed also so far tends to diminish

the general faculty of the owners or employers of capital. Accordingly, it has been maintained that on the faculty theory taxation should only be imposed on the net profits of gross incomes and on the net value of property. That taxation ought, as far as possible, to leave unimpaired the productive powers of the society — including land as well as labour and capital — may be regarded as logically implied in the faculty theory, and is practically one of the most important rules of finance.

But it does not follow that the general rule is best applied by being insisted on in every particular case. To exempt from taxation a certain minimum rate of profits would mean that more must be taken from the higher rates, and thus a premium would be placed on inefficiency, and a check imposed on enterprise.

The progressive system may be supported on the faculty theory on the ground that "the facility of increasing production often grows in more than arithmetical proportion. The rich man may be said to be subject in some sense to the law of increasing returns" (Seligman). Money makes money.

On the whole, it seems that *on the faculty theory* a moderate rate of progression might be advantageous as regards income, as it has proved to be as regards succession duties. "It is not very unreasonable," says Adam Smith, "that the rich should contribute to the public expense not only in proportion to their revenues, but something more than in that proportion."

4. Taxation of Unearned Increments. — The application, however, of the simple method of proportion to income or property may be further modified on the faculty theory.

We may consider (as before on the sacrifice basis) not only the amounts of the wealth, but the sources of such wealth. From the national point of view, the best system on the faculty theory is that which least impairs the productive powers of the society. Heavy taxation has been proved over and over again to be the greatest check to industrial development. But there is a large class of incomes which, compared with ordinary profits and wages, may be classed as "unearned," and it may be argued that taxation of these incomes does not impose a corresponding check on industry. "Both ground rents and the ordinary rent of land," says Adam Smith, "are a species of revenue which the owner in many cases enjoys without any care or attention of his own; though a part of this revenue be taken from him in order to defray the expenses of the State, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth and revenue of the great body of the people, might be the same after such a tax as before. Ground rents and the ordinary rent of land are, therefore, perhaps, the species of revenue which can best bear to have a peculiar tax imposed upon them. Ground rents seem, in this respect, a more proper subject of peculiar taxation than even the ordinary rent of land. The ordinary rent of land is in many cases owing, partly at least, to the attention and good management of the landlord. A very heavy tax might discourage too much this attention and good management. Ground rents, so far as they exceed the ordinary rent of land, are altogether owing to the good government of the sovereign, which, by protecting the industry either of the whole people or of the

inhabitants of some particular place, enables them to pay so much more than its real value for the ground which they build their houses upon. Nothing can be more reasonable than that a fund which owes its existence to the good government of the State should be taxed peculiarly, or should contribute something more than the greater part of other funds toward the support of that government." Later on, Adam Smith applies the principle still further, and argues that the gains of monopolists, whenever they can be come at, are certainly, of all subjects, the most proper for taxation. A similar argument may be applied to "*conjunctur*" profits, and those portions of *quasi*-rents that may be classed as "unearned."

5. The Benefit or Social Dividend Theory of Taxation. — According to this theory, taxes ought to be considered as payments for *valuable services rendered* by the State to individuals. The essence of this doctrine may be found in Adam Smith's reference to the revenues which are enjoyed under the *protection* of the State, and in his comparison of the individuals of a great nation to the joint tenants of a great estate. It is easy to show, as Mill does, that if protection is taken in its narrowest signification, as a matter of fact the poor need more protection than the rich, and as a consequence, that the *protection* theory would lead to *regressive* taxation. But Adam Smith's own application of the theory, already noted, to the case of ground rents and monopolies, shows that such a narrow interpretation is not justifiable, and has, certainly, never been appealed to in practice. The theory in its wider meaning implies that the State is a partner in all individual undertakings by providing, not only for security,

but for many other elements necessary and advantageous to their development. And as one of the members of every industrial partnership the State is entitled to a share in the profits. If, however, the theory, even in this extended form, is advanced as the only just basis of taxation, and if taxes are to be levied only and exactly in proportion to the benefits received, the foundation is obviously too narrow.

But the theory has a particular application in those cases in which the services rendered by the State and the benefits accruing to individuals are easily discovered and estimated, and it is of special importance in local finance. The terms *fees* and *prices* are, however, better adapted to the payments made for special services rendered by the State, and the principles are considered more properly in connection with state expenditure and municipal trading. It is misleading to attempt to connect the payment of taxes by individuals with their supposed share in the general benefits of government; it is better rather to emphasise the distinction between "fees" paid for particular services and taxes levied for general purposes (Seligman).

6. The Social Function of Taxation. — The benefit theory of taxation is closely allied with another theory, according to which the kinds and amounts of revenues derived from taxation should be adjusted according to their *social and political* effects. It is no doubt true that in all cases the indirect consequences of taxation are important, and in some cases the provision of revenue may be considered as of secondary importance. Protective duties, for example, so far as purely protective, are non-productive of revenue.

In the same way, the heavy duties on stimulants are often justified, not because (in fact) they yield a large revenue, but because (in theory) they check consumption.

Another of the social aims supposed to be specially adapted for attainment by taxation is the more equal distribution of the national wealth. Mill's peculiar proposals regarding the laws of bequest and inheritance were mainly justified by him on this ground, and in effect his proposal logically leads to succession duties, carried to the extreme limits imposed by the conditions affecting accumulation and evasion.

It is not necessary to revert to the general consideration of the communistic ideal. It may suffice here to observe that the same end may be promoted by the adjustment of expenditure, and it would seem better economy to aim directly at improving the condition of the poorer classes than to attempt to make the poor less poor, simply by making the rich less rich. Heavy progressive duties which lopped away all incomes above a certain amount would soon become unproductive, whilst a wealthy nation, by general taxes, may provide for an increasing number of social needs.

On the general question the summary of Professor Bastable seems temperate and well founded. "The results of financial experience are of some value in respect to the use of taxation for other than fiscal purposes. The taxing power has often been employed to encourage industry, to improve taste, to benefit health, or to elevate morals; but in none of these applications has the desired success been obtained. There is, therefore, a presumption against its use in remedying the inequalities of wealth.

Its definite and universally recognised function is the supply of adequate funds for the public services. To mix up with one very important object another different, and perhaps incompatible one, is to run the risk of failing in both. . . . If the socialistic régime is the goal to be aimed at, there are more direct and more effective modes open than the manipulation of taxation."

There are, in brief, the multitudinous methods of legal enactment and of public expenditure.

7. The Principle of Formal Justice. — Finally, whatever basis of taxation be adopted, the principle of *formal justice* noticed in the conclusion of Adam Smith's first canon must be considered. If it is just — for any of the reasons usually assigned — to tax A, it is just to tax B under precisely similar circumstances. Thus stated, the principle seems purely abstract and as empty as any other pure form of thought. On the analogy, however, of the principle of equality before the law and similar political principles, it is easy to give it a material content. For fiscal purposes we may substitute the term *practically* — for precisely — similar. Thus, the possible extension of a tax to all similar cases (or conversely, the remission) may suffice to destroy the *prima facie* reasonableness of extension (or remission). We shall see later that the same principle is of vital importance in the correlative department of expenditure, and as we have already seen, it is one of the general limitations to governmental action.

8. Adam Smith's Other Canons of Taxation. — The three remaining canons of Adam Smith give more particular rules for the attainment of equality and productivity in the whole tax system by reference to the methods employed

in the imposition and collection of particular taxes. They are, for the most part, comparatively simple and require but little explanation, although the course of history and the present actual condition of different nations show that they are only carried into effect with considerable difficulty.

The *second* — the canon of *certainty* — lays down that, "The time of payment, the manner of payment, the quantity to be paid, ought to be clear and plain to the contributor and to every other person." The positive elements in this maxim bring out the importance of definiteness and publicity. On the negative side it is aimed against the arbitrary exactions of the sovereign power and the jobbery and abuses of its officials. Apart from the general social and political evils connected with the exercise of arbitrary power, uncertainty of taxation involves an economic waste. *Ad valorem* duties on imports are open to the objection that the importer is never certain in what grade his commodity will be classed for taxation. The method of declaration which applies to a large part of the returns to the British income tax fails in publicity, and the failure in publicity leads to irregularity and uncertainty.

The *third* — the canon of *convenience* — enjoins that, "Every tax ought to be levied at the time and in the manner in which it is most likely to be convenient for the contributor to pay it." It is justified, not only on the general grounds of good government, but also on the special economic ground of the greater productiveness of taxes which satisfy this condition. It is found possible to raise a considerable revenue by taxes on commodities, the payments of which are made by the consumers in insensible

portions, when it would be impossible to collect the same amount by direct taxation at comparatively long intervals.

The *fourth* — the canon of *economy* — has for its governing principle that, "Every tax ought so to be contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State." Taxes may break this rule by requiring a large number of officials for their collection, by involving restraints on trade and production, by encouraging evasion, or by causing unnecessary vexation, for "though vexation is not strictly speaking expense, it is certainly equivalent to the expense at which a man would be willing to redeem himself from it."

9. Other Rules of Taxation. — To these general canons of Adam Smith the following may be added, most of which are implied in different passages of his treatment of taxation, but have been expanded more fully and emphasised by subsequent writers. (*a*) A given amount of revenue is as a rule more conveniently raised, both from the point of view of the government and its subjects, from a small number of very productive taxes than from a larger number with smaller returns per unit. This was one of the principal reforms advocated by Adam Smith with reference to the British customs duties, and was carried into effect by Sir Robert Peel and his successors. The inextricable confusion of the customs duties levied before these reforms, and the unproductive character of most of them, can only be realised by reference to the details of the history of taxation. It is thought, however, by some financiers of the first rank that this concentration has been carried too far in the United Kingdom, and that the bur-

den of indirect taxation would be less felt if spread over a larger number of commodities. The process of simplification and concentration has also been partially applied to the direct taxes, imperial and local.

(*b*) A good system of taxation ought to provide for a self-acting increase in the revenue in proportion as wealth and population and the consequent demands of governmental expenditure increase. Thus a land tax of a fixed amount per acre is in general much less advantageous than a proportionate amount of rental. The income tax and taxes on stimulants have the advantage of showing an increasing return with increasing wealth and numbers.

(*c*) Those taxes are best which yield a steady calculable return. The calculations of the estimates for the *Budget* in the United Kingdom are now made with extraordinary exactness. The reason for this rule is found in the advantage of adjusting normal expenditure to normal revenue.

(*d*) Those taxes are to be preferred which in case of need can be most conveniently increased in amount without involving new machinery or increased expenditure in collection, *e.g.* the income tax in fact, and in theory the tax on beer.

(*e*) At the same time, in the progress of society it may be expedient to abandon old sources of revenue and to adopt new methods under the new conditions, notwithstanding the disadvantages which *ceteris paribus* attach to all changes in taxation.

Finally, it may be observed that if, as is almost inevitable, there is, as regards any proposed tax, a conflict of advantages and disadvantages as tested by the canons and

rules of taxation, the less important rule must be surrendered, the importance being judged according to circumstances. Adam Smith, for example, states emphatically that the experience of all nations shows that a very considerable degree of inequality is not near so great an evil as a small degree of uncertainty. Again, productiveness covers a multitude of sins, and as Professor Bastable remarks, "The successful administration of the State is the final object, and therefore convenience or even equity may have to yield to productiveness."

It is also important to point out explicitly that all the rules must be applied to a *system of taxation as a whole*. There are, of course, some taxes which would be bad in any conceivable system of taxation; but, in most cases, a criticism of a particular tax is of little value unless consideration is also given to the other taxes with which it is combined.

In considering the effects of the system of taxation and of its component parts, it is always necessary to take into account the real incidence. It is of no avail to set up an ideal standard of equality, if the actual methods adopted, though nominally and ostensibly in accordance with the standard, lead to inequality. No part of the theory or practice of taxation has given rise to so much controversy as the real incidence of various particular taxes. The "shifting" of taxes may lead not only to inequalities, but to injurious effects on the productive powers of the society as a whole.[1]

[1] Abbreviated from *Principles*, Book V, Chaps. VI–VIII. See Bastable, *Public Finance*, 3d ed., 1903 — the standard work in English; Seligman, *Progressive Taxation* and *Essays in Taxation*; Plehn, *Public Finance* — a most useful text-book; Cohn, *Science of Finance*.

CHAPTER IV

INCIDENCE OF TAXATION

1. Direct and Indirect Taxes.—One of the oldest and most important divisions of taxes is into "direct" and "indirect." A direct tax is defined by Mill — and this is the definition generally accepted — as a tax demanded from the very persons who it is intended or desired should pay it. An indirect tax is demanded from one person in the expectation and intention that he should be able to transfer it to another. Even as regards direct taxation, it may well happen that, although the person who first pays the tax is the person who bears the burden in the sense intended by the government, yet indirectly, in ways not contemplated by the government, part of the original burden and part also of the additional burden incidentally created may be shifted to others.

Suppose, for example, that the State imposes a tax upon houses, and that it divides the amount payable in definite proportions between the owner and the occupier, and duly collects these proportions from each separately. Here we have apparently the simplest examples of direct taxation possible.

But an examination of the incidence of the house tax shows that under certain conditions part (or even the whole) of the nominal payment of the occupier may be

shifted to the owner — that is to say, in consequence of the tax the occupier may pay so much less rent, whilst under other conditions, part (or even the whole) of the nominal payment of the owner may be shifted to the occupier by a rise in rent. And apart from this redistribution of the house tax itself between owner and occupier, there may be indirect effects upon agricultural rents and upon particular classes of profits.

Again, nothing could appear more direct and simple than the incidence of succession duties; the former owner of the property is dead, and the State takes a part to itself.

But if it is known that after death the State will take a large share, a stimulus is at once given to evasion, *e.g.* through the checks to accumulation, the encouragement of consumption, and gifts *inter vivos*. It is thus possible that heavy succession duties might prejudicially affect the wages of labour. And there can be no doubt that historically, in countries that are burdened with excessive taxes, apart from the share supposed to fall on labour, there is an additional burden due to the contraction of enterprise and accumulation.

If, however, in the case of taxes nominally direct, we have to penetrate beyond the seen to the unseen, still more necessary is the study of real incidence in the case of taxes ostensibly indirect. It may happen first that the intention of the government that the tax should be shifted from the original payer is not realised at all or only partially; secondly, it may happen that the part that is shifted is shifted in a way not contemplated; and thirdly, there are all the after effects and indirect consequences as in the case of direct taxation.

It may also happen that the imposition of a tax, whether direct or indirect, will not only impose a burden, intended or not intended, but may incidentally create an advantage and confer a benefit, sometimes intended, sometimes not. Just as pauperism is attracted by high expenditure, so capitalism is attracted by low taxation, and thus heavy taxation in one district gives an advantage to other districts lightly taxed. Protective duties are intended to protect, but other taxes may create monopolies not originally intended.

It is clear, however, that, whatever meaning or meanings be given to equality of taxation, we must always refer to the ultimate real incidence with all its burdens, direct and indirect.

In every problem of incidence, for the complete solution, two questions must be answered: first, who ultimately pays the tax received by the State; secondly, who bears the burdens or enjoys the advantages incidentally created. In the discussion of the general principles we are mainly concerned with the first question, the incidental burdens and advantages being subject to variations according to the nature of the particular tax.

2. The Incidence of Taxation as determined by Law and Custom. — The general problem of incidence is a problem of distribution, and for the solution we must refer back to the general principles already examined. And it must be observed that just as distribution cannot be entirely reduced to exchange, so neither can the incidence of taxation be considered merely as an application of the theory of value.

The power to shift the payment of a tax or to recoup

the payment from another source depends, in the first place, upon the influence of law and custom in the widest sense of the terms. This influence may be so great that there is no possibility of shifting the tax otherwise than as directed by the rules laid down by the State or submitted to under the customs of the society, though even in this case there are indirect consequences, both in the way of burden and of advantage.

The influence of law and custom may be best observed in societies in which exchange is not yet of fundamental importance, as, for example, in those under the dominance of feudalism or village communities.

We find in the development of the incidence of taxation an illustration of the universal progress from status to contract. At first, the force of law and custom directs the transference of the tax to its most minute ramifications; gradually this compelling power is limited to the collection of the tax from the original payers, they in their turn transferring the whole or part of the burden, according to the principles of contract and exchange.

3. Incidence of Taxation as determined by Contract and Exchange. — In modern times the State levies certain taxes, — on persons directly, or indirectly through commodities, — but the taxed persons may be able to shift the burden according to various economic conditions. The ultimate incidence is no longer altogether determined by the compulsion of law and custom, and the rapacity of the collectors, but partly by the voluntary actions of individuals.

When a tax is imposed on any person (with no legal power of transfer), he is naturally led to reconsider his

whole economic position, so that he may make the burden a minimum on the whole. The possibility of compulsory legal transference being now excluded, he can only get rid of his burden (wholly or partially) by a change in his bargains — and it takes two at least to make a bargain.

It is quite clear that the mere fact of the imposition of a tax will not in general be sufficient reason for the original taxpayer to ask and receive an indemnity from others. If we take the terms *seller* and *buyer* in the widest sense, — as applied to the purchase and sale of land, labour, and capital, either absolutely or for certain uses, for certain times, under certain conditions, — we may suppose that the State extracts from the seller a certain part of his price, or imposes on the buyer an official charge for the privilege of being allowed to buy.

4. The Immediate Effects on Price of a Tax. — The immediate effect of a tax on the buyer (the conditions of supply remaining the same) will be a fall in price (as paid to the seller). But the extent of the fall is indeterminate. Before the price has fallen to the full amount of the tax, the withdrawal of supply in response will create a new equilibrium. If the tax is imposed on the seller (the demand remaining the same), the immediate effect is to raise the price paid by the buyer. But again the extent of the rise is indeterminate, because before the price has risen to the full extent of the tax, the check to demand will produce a new equilibrium. It makes no difference theoretically whether the tax is taken in the first place from the buyer or the seller; the ultimate incidence depends on the shifting, and the shifting on the elasticity of demand and supply. The general principle

is that the tax inflicts more loss on either party the less the elasticity of that party's demand or supply, other things (including the other party's elasticity) being the same.

If the buyers are taxed in the first place, they demand so much less, how much less depending on the elasticity of their demand; and the competition of sellers reduces the original price — the degree of the fall again depending on the elasticity of their supply. If the rise in price would decrease greatly the quantity demanded (a very elastic demand), and a similar fall in price would have very little effect on the quantity offered (a very inelastic supply), the greater part of the tax will fall on the seller.

If the sellers are taxed in the first place, they will so far offer less, and the competition of unsatisfied demand will tend to raise the price; and again the new price will depend on the elasticity of demand and supply.

In general, however, except in the extreme or limiting cases, the seller will always receive something less and the buyer will pay something more than the original price, the distribution of the burden being dependent on the relative elasticities. And in general, also, the effect of the tax will be to diminish the amount bought and sold.

In the limiting case of perfect non-elasticity of demand, if the buyer is determined to have so much *quand même*, the whole of the tax would fall on the buyer; and similarly, if there is perfect non-elasticity of supply, and the seller must sell *quand même*, the whole of the tax would fall on the seller. If both demand and supply are perfectly non-elastic, the distribution is indeterminate. If

both are perfectly elastic, that is, if the smallest addition to the price will kill demand, or smallest subtraction kill supply, the tax kills the market, and there is no incidence because the tax cannot be collected.

5. Ulterior Effects of Taxation on Prices. — It must be borne in mind that in the preceding section only the immediate effects on markets prices have been considered.

The ulterior effects on prices will depend on the various conditions affecting production or supply, with the reaction on demand.

These conditions can only be stated in extremely general terms if they are to be applicable to production (or supply) in the widest sense, including the production of labour and of capital, and also of the adaptation of land and natural agents for productive purposes.

Amongst such general conditions — which have to be taken account of in the determination of the incidence of particular taxes — are: (*a*) The influence of competition and monopoly respectively, which again depend for their efficiency or purity on a variety of causes, *e.g.* the mobility of labour and capital and of land (in the sense of adaptation to different uses or transference to different owners), and the power of voluntary or state-aided combination. (*b*) We have to consider whether the thing produced follows the law of increasing, decreasing, or constant return — whether the available supply is forthcoming at a uniform cost or at different costs. (*c*) We must take into account the method adopted in taxation, whether the tax is *ad valorem* or specific, proportionate or graduated, whether imposed directly on the final product or at prior stages. (*d*) We must consider whether the tax is gen-

eral or particular, or equal or unequal, and how far it affects substitutes or correlated articles.

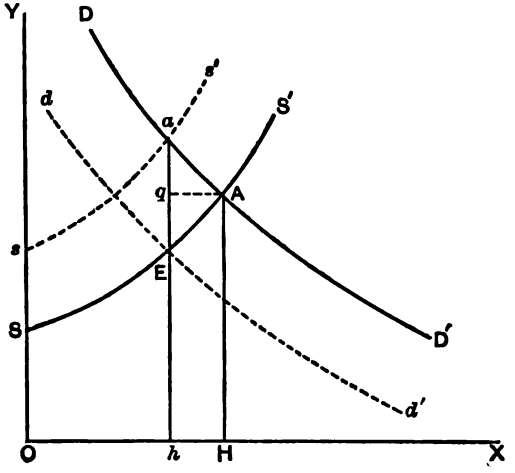
The general nature of these conditions and of the subjects covered by taxation shows that the general principles of the ultimate incidence of taxation must be considered in reference to the various classes of taxes, and it will be found that these conditions are of varying importance and operate in different combinations in different cases.

The theory of the incidence of taxation involves, indeed, an application of all the economic principles, theories, tendencies, and disturbances already examined.[1]

[1] The more difficult parts of *Principles*, Book V, Chap. X, are here omitted. See Seligman, *Incidence of Taxation;* Edgeworth, "Pure Taxation" in *Economic Journal.*

NOTE

The effects of the immediate incidence of a tax can be best expressed by the use of curves. The supply curve, SS', expresses the general law of *market supply, i.e.* that in any market the quantity offered tends to rise with every rise, and to fall with every fall in price. DD' is the demand curve.



If the buyer pays the tax aE, Eh will be the price received by the seller; if the seller pays the tax (receiving ah from the buyer), his net receipt is still Eh, and at this price Oh will be offered, and at the price ah, Oh will also be demanded. Therefore Oh is the quantity demanded and offered at the net price to the seller of Eh, and at the gross price to the buyer of ah. And the result is the same whether the buyer or the seller pays the whole of the tax in the first place.

The price ah exceeds the price AH by na, and the price Eh is less than the price AH by En, and na plus En equals the tax. It will be seen that if DD' becomes more elastic, the proportionate rise in price above the original is less, and in the extreme case the whole tax falls on the seller.

Conversely, demand remaining the same, and elasticity of supply increasing, there is a greater rise in price to the buyer.

If the tax is collected in any definite proportion, indicated by q, from both buyer and seller, the result is also the same. The seller pays Eq to the state and the buyer qa; but the seller, as before, receives Eh net, and the buyer pays ha gross, namely, qa to the state and hq to the seller. If the buyer sought to retain qE, at the price ah minus qE, more would be demanded than Oh, and at the price Eh minus Eq less would be offered.

Thus Oh is the equilibrium quantity, hE the seller's net receipt, and ah the buyer's gross payment in any case.

But the rise of ah above AH and the fall of Eh below AH will depend on the elasticity of the two curves, DD' and SS'.

Oh is obviously less than OH; ha is greater than AH, and Eh less than AH, except in the limiting cases when DD' or SS' become horizontal or vertical straight lines.

By way of further explanation, it may be added that the SS' curve shows how much is offered in response to certain prices; if, by a tax, so much is extracted from each of these prices, the whole supply curve is raised. Conversely of DD'. If the buyer must pay so much more per unit, the whole demand curve is lowered.

The effect of a tax which is paid by the buyer is equivalent to a fall in demand. The desire to possess (relatively to other things), and other conditions remaining the same, the buyer will pay the same total price as before; therefore, if part goes as a tax, he offers so much less to the seller in every case.

Similarly, if the tax is taken from the sellers, they will sell for the same set of net prices as before; that is equivalent to a rise in supply. A higher price is needed to extract the same supply.

CHAPTER V

TAXES ON RENT AND LAND

1. Taxes on Pure Economic Rent: Agricultural Land. — Economic rent (pure) of agricultural land is generally mingled in practice with other forms of revenue due to capital or labour, and not merely to the natural qualities of the soil. But for theoretical purposes we may assume that the economic rent may be isolated from these other elements. In the normal case the produce-rent will depend on the excess above that of the margin, and the money rent will depend on the amount of produce and the price per unit which is determined by the marginal cost of production. Thus economic rent is a surplus which depends upon natural conditions that may vary to any extent, and on price, which is independent of rent.

We may further assume for a first approximation that there are separate owners of the various portions of land, that the owners are not in combination, and that the lands are let by competition every year on an accurate estimate of the produce-surplus and its price.

And, also, we may assume that there is only one kind of produce, or that the land can be let only for one purpose.

In measuring the economic rent we do not take units of land, but units of productive power (labour and capital) applied to different qualities of land. The rent arises

from the different return to the same amount of power applied under different natural conditions.

With these various assumptions it is quite clear that a tax on economic rent cannot be shifted by landowners. It cannot be transferred to the consumer of the produce, owing to the competition of the marginal land that pays no rent and therefore no tax, nor to the farmer, since competition leaves him only ordinary profits.

The amount of each particular rental depends upon units of surplus produced (varying to any extent according to the superior natural conditions), and on the marginal price, which is independent of these superior conditions. And, accordingly, a tax that strikes the surplus only, remains where it first falls.

Even if the tax is very unequal, and is such that after payment superior land yields a lower net return than inferior land, there is no readjustment of the burden.

The same reasoning applies if we consider all the land to be of the same quality, and the surpluses that constitute rent to arise from the different returns to successive doses of capital, or if, as is usual, we find the extensive and intensive application of the law of diminishing returns conjoined.

Also in the case of simple scarcity-rent where, though lands and costs are uniform, there is a marginal rent (or differential profit over ordinary employments of capital), the tax lies where it falls.

Generally, under the conditions laid down, a tax on economic rent cannot be shifted by the owner of the land; and if levied in the first place on the occupier, he can retain it from his rent, the mobility of capital acting as

effectively as if he were empowered to make the transfer by the law of the land.

2. Taxes on Economic Rent: Building Land. — Similar reasoning may be applied *mutatis mutandis* to the case of building land.

To begin with the simplest case: let it be supposed that the land is only of use for building, that the same amount of capital is applied to each site, that there is perfect mobility of capital, and that the economic rent varies solely with advantage of situation. Under these conditions it is clear that a tax on economic rent falls entirely on the landowners. The builders are immune because their capital can be applied to other purposes, and the occupiers escape because the land cannot be used otherwise, and already the landowners have obtained the best results by competition.

The result is the same if we suppose that the buildings are extended in height until the marginal storey is reached.

To vary the conditions, assume next, that some of the land, *e.g.* the suburban land, can be used for agriculture. The agricultural rental will depend on the conditions affecting agriculture generally, and the peculiarities of the land; so that we may say that the agricultural rent is independent of the urban conditions. If, then, a tax is imposed on building, but not on agricultural, rental, the tax on ground rent on the margin will obviously fall on the occupier. Land will not be devoted to building unless it gives at least the agricultural rent plus the tax.

A house-rent tax is imposed on the building rent and ground rent conjoined. If the building rent is regarded as determined by the ordinary rate of profit, and the occupier's demand is inelastic, a tax on the total house rent

levied from the occupier must fall in the first place on the occupier. But on the same assumptions he cannot transfer any part to the landowner. If, however, the demand is elastic, and as before the building rent constant, part of the tax will be thrown on the landlord; but the amount will depend on the elasticity of demand. And the transference can only take place, of course, on the assumption that the contracts for the hire of the land are subject to constant renewals on any change of circumstances.

It follows, then, that in general a tax on ground rents, if intended to strike the landlord, should be levied directly, and not left to be shifted by the occupier on the renewal of his lease. And the longer the lease, still more necessary is it to levy the two portions independently.

There is, however, always the practical difficulty of determining how much of the total house rent is to be ascribed to the ground, and how much to the building, when we are considering buildings erected under different conditions. There is, besides, in business premises, the value of the good-will, and in ordinary residences the value of the tenant right as shown by the general condition and amenity.

Still the fact remains that during the lease any new tax levied from the occupier cannot be shifted, and on the expiry of the lease may not be shifted in the proportion intended.

Any tax intended to strike "land values," which really strikes the occupiers of houses, has important ulterior effects. As regards dwelling-houses, it may lead to overcrowding and may check improvements, and as regards businesses, it may check their development or in some cases may fall on the consumers of the articles supplied.

On the other hand, a special tax on land suitable for building which is being held up for the rise in value, and in the meantime is only rated at its agricultural or unbuilt value, would tend to throw the land sooner into the hands of the builders, and so far in the meantime general house rents would fall. But the ulterior effects might be that lands would be used for inferior buildings which it would be expensive to remove later on, so that ultimately the lands would not be so well occupied and would yield lower rents and also lower taxes, and besides would have buildings not so well adapted for the use of the tenants.

3. Taxation of Land Values: Practical Conclusions. — The preceding sections indicate the principal theoretical difficulties in connection with the incidence of taxes on land, and by varying the hypotheses, and by making different combinations, many different cases might be presented. Enough, however, has been brought forward to justify some important practical conclusions regarding the proposal to tax "land values."

(*a*) Any tax intended to strike pure economic rent should be taken directly from the owners of that rent. The shifting by the occupier is uncertain, and the uncertainty causes inequality. The partial evasion by the occupier (*i.e.* legitimate evasion), as by taking inferior accommodation, or by charging higher rates to the customers of his business, is productive of economic loss that may far more than neutralise any gain of revenue to the State or the municipality.

(*b*) It follows also that if these inconveniences are not to ensue, the amount of the true economic rent must be accurately determined, and the ownership definitely

traced. Both of these problems present great practical difficulties. True economic rent is in practice nearly always combined with other forms of revenue. The rent that is paid for agricultural land is partly, and very often largely, simply interest on the various forms of capital sunk in and about the land. This interest is, in general, calculated at a low rate. Any exceptional taxation on "economic rent" that actually struck profit-rent, would check agricultural improvement, and lead to the deteriorations of land already improved (Adam Smith).

Again, as regards the ground rents of urban lands, although the pure economic rent seems, at first sight, more easily ascertained, it is, as a matter of fact, very difficult to determine accurately, and there must be a considerable margin of doubt. If houses were tents or tabernacles that could be easily shifted, and required no connections with systems of roads, water, lighting, drainage, etc., the economic rent of a "stance" would be simple enough. But the more complicated the building and its connections, and the more it is adapted for special purposes, so much the more difficult is it to separate the pure economic rent of the ground from other elements included in the gross rental.

Further, even when the amount of the pure economic rent has been determined, there is still the difficulty of discovering the true owner, that is to say, for the purposes of this exceptional taxation. The "true" owner from the point of view of those who advocate this particular penalty is in the position of the "original thief" of stolen goods. Just as a purchaser in market overt is not held to be liable to restore the goods, so neither should the person who

has paid the full value for land to the original thief be liable to restore the land (or its value) to the original owner — the community. But in old countries the original thief has long ago been lost sight of — he cannot be tracked through the maze of contracts.

It is said, however, that apart from this original suppression of free land, there is a continuous exploitation by private owners of the increasing revenues really due to the growth of the State, or more precisely to the environment of the land. This is, no doubt, perfectly true in progressive societies under certain conditions — though not necessarily and universally true as is shown by the great fall in the rental of some agricultural lands in England in recent years, and in the decaying parts of some towns and cities. But supposing that this unearned — this continually "becoming" increment — could be separated, it would still be difficult to tax the true owner or the actual exploiter. If the exceptional tax were imposed on the sales of lands, it would check the transfer of lands, and a corresponding tax carried over to the lands not sold would be difficult to estimate accurately. If the tax were imposed on new leases, it would give a relative advantage to the old lessees; and if they were taxed accordingly, there is again the difficulty of estimation.

(*c*) The proposal to tax land values — in the sense of "unearned increments" — is simple only in appearance. It is not only difficult to distinguish in rentals between unearned and earned, and between the respective owners of these portions, but it is difficult to know when the application of the principle is to stop, and the fear of creating precedents is one of the greatest and most salutary

checks on governmental interference. It has already been explained that there are large unearned elements in every species of revenue. But there can be no question that any attempt to seize them as they arise would cramp the general activity of the society, and to seize them after they have been suffered to accumulate would be an *ex post facto* policy which would quite as effectively encourage the others not to make any such gains.

It is, of course, assumed in this argument that the seizure is complete and differential, for such additions to property and income are of course subject to general taxation of an ordinary kind. There can be no question that the attempt generally to differentiate between earned and unearned income would logically end in socialism, and would destroy the efficiency of the present system.

(*d*) And thus we again reach the position that, if the ultimate aim is socialism or any approximation thereto, it is better to try to attain the end, not indirectly by exceptional taxation, but directly by more general methods. And still more is this the case if the reforms contemplated are not so subversive of the present system as to be fairly called socialistic. There are many positive abuses connected with the private ownership of land, and there are many defects resulting from a want of land for public purposes. But these abuses and defects cannot be counterbalanced or obviated merely by the absorption of unearned increments.

By the theory of English law it is said that the owner of the land can prosecute for trespass those who sail above it in a balloon, although happily his remedy would consist only in the damages proved to result. But very few people

know anything of the law of trespass, and the threat of the utmost rigour of the law placarded on multitudes of notice-boards throughout this country is a ridiculous exploitation of the law-abiding habits of the community.

The provision of open spaces in crowded neighbourhoods is now considered so important that great expense is incurred in widening streets and making gardens in the older parts of towns and cities; and yet we find that such cities and towns are continually extended into purely agricultural land without any adequate reservation of space for light and air in the dwellings, convenience of communication, or facilities of recreation. Instead of attempting to obtain the unearned increment from new, crowded dwellings, it would be far better from every social standpoint to extend the area of building, not by taxing vacant building lands, but by compelling all new building land to contribute a share toward providing for the perpetual vacancy of sufficient land for public purposes. As it is, a town is extended as if the inhabitants intended to fortify it with a wall able to resist modern artillery, and as if the means of communication were restricted to muddy mediæval roads.

That a part of newly occupied land should be reserved for public purposes is a custom of the highest antiquity. Mr. Seebohm, in his classical work on the English village community, was unable to account for the origin of little odds and ends of unused land which have from time immemorial been called "no man's land," or "any one's land," or "Jack's land." Mr. Gomme,[1] however, has suggested

[1] The facts cited are taken from Mr. Gomme's *Village Community*, pp. 114, 115.

that an explanation may be found in a Scottish custom.[1] Clootie's croft or the gudeman's field consisted of a small portion of the best land, set apart by the inhabitants of most Scottish villages as a propitiatory gift to the devil, on which property they never ventured to intrude. It was dedicated to the devil's service alone, being left untilled and uncropped, and it was reckoned highly dangerous to break up by tillage such pieces of ground.[2]

[1] Quoted from Henderson's *Folklore of Northern Counties*, p. 278.

[2] Cf. Book V, Chap. XI, of *Principles*, and *The Final Report of the Royal Commission on Local Taxation*.

CHAPTER VI

TAXES ON CONSUMABLE COMMODITIES

1. Methods of Taxing Commodities. — Under modern conditions, taxes on consumable commodities are levied in three ways: (*a*) directly on the consumer, *e.g.* licenses to use certain things; (*b*) indirectly through the inland producer, *e.g.* excise duties; (*c*) indirectly through the exporter or the importer — customs duties. The term *consumable commodities* must be taken in a large sense, *e.g. qua* the dog tax, the owner is the consumer of the commodity dog, and by analogy the employer is the consumer of his liveried servants (and not the converse).

(*a*) Of taxes that are imposed *primarily* on the *consumer* the most important in modern times is the house tax, if the occupier is regarded as the consumer of that commodity.

Other direct taxes on consumption may be described as licenses on use. Such licenses are of very ancient origin.

Under present conditions direct taxation of the consumer is not considered a convenient source of revenue except to some extent for local purposes. The great objection to such taxes is that they are inconvenient to the taxpayer, and unproductive to the revenue. In the United Kingdom the annual average (on carriages, dogs, guns, etc.) from this source is now only £1,860,000.

Some of these licenses, however, are retained partly for police purposes.

(*b*) The present *excise* duties — levied on the inland producer — may be connected historically with direct consumption taxes. In England, for a long period, the monarch lived of his own, but he also took directly much consumable wealth in the course of his journeys through the country. The royal court travelled like a host of locusts. The next step in advance was the development of the right of purveyance or preëmption. The king paid for his commodities, but he did so at prices fixed by his own officers and with tallies that were not always honoured on presentation. In the literal signification these exactions were *excises*.

Excise duties may also be traced to another source. The king possessed large feudal rights in the shape of market dues and tolls, and the transition from exactions of this kind to taxes on sales was natural and in most countries was accomplished very early.

The crown also enjoyed certain prerogatives for the regulation of trade. Many fines were imposed and licenses granted in matters affecting trade and merchandise. From regulation to taxation the transition also seemed easy and natural until the revolt of the American colonies shattered the survivals of this mediæval prerogative.

(*c*) The *customs* duties — levied on exports to and on imports from foreign countries — are of very ancient origin. The term *customs*, or its Latin equivalent *consuetudines*, was at first applied to all kinds of customary payments, including *inter alia* various kinds of ecclesiastical dues. Customs duties in the modern sense may be

traced like excise duties to different sources. *Tolls* were levied by the king at the ports; and *licenses* were granted conferring exemptions and privileges.

The history of the British customs and excise duties in the nineteenth century, when they had become a fearfully tangled growth, is the best possible commentary on the principles of taxation laid down by Adam Smith and developed by his successors. There is not one of the great canons which we are accustomed to take for granted which was not transgressed in every conceivable application before the conclusion of the great French war (1815).

A parliamentary report of 1829 showed that £6,000,000 was raised by taxes on the raw materials of manufacture, — the worst of all methods, because advanced by the producer at the first stage, — whilst, *per contra*, protective duties were levied on every manufacture whatever — on those not specially enumerated 20 per cent, and in some cases 75 per cent. Agriculture was protected still more — there were not only corn laws but animal laws (the duty on an ass being 10*s*. and on a horse £1), whilst the importation of animals used as food was absolutely prohibited. By the customs tariff of 1842, 262 articles of raw materials of manufacture yielded about £2,000,000, and 200 finished manufactures yielded less than £500,000; and taking a general view we find that there were 704 articles which altogether yielded a little over £1,000,000.

The excise duties give corresponding results: many were unproductive and many were prolific in evil results (*e.g.* taxes on bricks, glass, paper, soap).

The period of reform began practically in 1842 under Sir Robert Peel. In that year he reimposed the income

tax, which enabled him to abolish or reduce many of the most injurious customs duties, *e.g.* duties on raw material. In 1845 the income tax was renewed for three years to effect further reforms, and 430 articles were taken off the tariff and other reductions were made. In 1846 the Corn Laws were repealed, and animal food (alive or dead) was admitted free, and many other customs duties (as also the excise on glass) were abolished. The same policy was continued under Lord John Russell, the Navigation Act being repealed in 1850. In 1853 Mr. Gladstone became Chancellor of the Exchequer, and 123 articles were set free from customs and 133 reduced. The Crimean War checked the progress of reform, but the final result was the reduction of the tariff to such a degree of simplicity that practically only four articles — spirits, tea, tobacco, wine — were retained for revenue, the rest of the tariff being either to support excise duties or to prevent substitution.

2. The Incidence of Taxes on Commodities. — The incidence of taxes on commodities furnishes a good illustration of the general principles already examined.[1] If the tax is imposed directly on the consumer, it so far tends to check his demand. This check to demand so far will cause a contraction of supply when equilibrium is restored. The extent of the contraction will depend partly on the elasticity of demand,[2] which again depends on various factors (*e.g.* the possibility of substitution) and partly on the conditions of supply. The ultimate effect on price will vary according as the commodity follows the law of increasing, diminishing, or constant return, and according

[1] See above, Book V, Chap. IV.

[2] *Ibid.* Book III, Chap. II, Sec. 1.

as it is produced under free competition or under a complete or partial monopoly.

If the tax is imposed in the first place on the producer or the dealer, he will endeavour to shift it to the consumer, and whether he can do so or not depends upon similar conditions. In fact, theoretically, it is a matter of indifference from whom the tax is collected in the first place, and practically the method of collection is generally only of importance as regards the real burden on the first imposition of the tax.

In general, the price will rise to the consumer more than in proportion to the tax, because the supervision necessary for the tax will prevent various economies and improvements; the rise in price will check demand and contract supply, and there will thus be a further check to economies and improvements; a large capital may be required to advance the tax, and this advantage to large capitals restricts competition and increases the power of monopoly and combination. The truth in these positions is abundantly illustrated in the history of British finance.

At the same time, however, the exceptions are of interest theoretically. If the commodity follows the law of diminishing return, the tax will cause a recession of the margin, and the marginal cost being less apart from the tax the price will so far rise less than by the amount of the tax. If, however, the commodity follows the law of increasing return, the price will rise through the contraction of supply more than in proportion to the tax. If there is a monopoly, in general the price will not rise to the full extent of the tax, and in certain cases it may not rise at all, the whole tax falling on the monopolist.

It is to be observed that the producer may, in certain cases, be able to shift part of the tax to wages, as the contraction of supply will lower the demand for labour.

Ultimately, however, the relative net advantages of the kinds of labour involved must be restored, although if there has been a monopoly element in the wages the loss will not be recovered.

In all cases of internal taxation it is, of course, assumed that corresponding customs duties are levied on similar commodities and possible substitutes.

The determination of the incidence of import duties depends on the theory of foreign trade, and, in my opinion, is best worked out in terms of prices. Suppose that a heavy import duty is suddenly imposed, the foreign producer will not send the product to the taxing country, if other free markets are open, unless the importer pays the tax. The payment of the tax will, however, check the demand, and there will be a consequent reaction on production. If the taxing country has been taking a large part of the foreign supply (a partial buyers' monopoly), the foreigner may be compelled to bear part of the tax to lessen his loss; and if the commodity is more or less of a producers' monopoly, or is produced according to diminishing return, the price to the taxing country will never rise to the full extent of the tax. If, on the other hand, the demand of the taxing country is relatively small, if supply can be readily adjusted, and if other free markets are predominant, the whole of the tax will fall on the consumer, and the price may rise more than by the amount of the tax, owing to the indirect influences already noticed. Most commonly

the tax falls (with the surcharges) on the consumer, and it seldom happens that the conditions are such that it will strike the particular foreign producer seriously. He will seek other employment for his capital or other markets for his produce. It must be remembered also that the case of a monopoly is much more rare than may appear at first sight. It does not follow that, because one country only produces a certain commodity, it is therefore sold at a monopoly price. In order that this may be done, there must be perfect combination amongst all the producers, as appears to be the ideal of modern trusts. But under modern conditions there are very few important commodities, if any (having regard to effective substitutes), which are confined to any one country, and a combination between producers of different countries is still more difficult to obtain.

The case of diminishing return is also practically of still less importance. If, for example, Britain imposed a tax on wheat, it is doubtful if any part of it would fall on the foreign producer.

When equilibrium is restored after the imposition of the tax, it is plain that the price in the taxing country will differ from the price in the producing country by the amount of the tax (and its charges) and the cost of carriage. In general, the price will be determined by the conditions of supply and demand in the country of origin, and the taxing country as a rule has only a minor influence, relatively to the whole commercial world, upon the demand.

The ulterior effects consequent on the disturbance of international trade and the necessary readjustments will

also, in general, be unfavourable to the country imposing the tax. The diminution of imports will check exports either directly or indirectly, since imports are paid for by exports. It is true that the productive power formerly employed in making these exports may be used to make commodities for the home market, and at the same time also the taxation of the foreign products may lead to an increased demand for the products of home labour. This, indeed, is the foundation of one part of the theory of protection. And it is clear that if before the duty the productive power of the country had been most advantageously distributed, the redistribution consequent on the duty must involve some loss. In brief, any import duty so far restricts the aggregate of foreign trade, and in general such a contraction is disadvantageous, although there are exceptions.

An import duty to be effective for revenue purposes must be supported by corresponding excise duties on the commodity and its substitutes. Similarly the commodity must be taxed, whatever its use. Thus it is said that the new import duty on sugar will also fall on blacking into which molasses enters, and to some extent also it will fall on beer and ham.

The imposition of an export duty on coal by the British government in 1901 has given a special interest to the general theory of such duties. The popular idea is that because a tax on an import falls on the home consumer, therefore a tax on an export will fall on the foreign consumer. But this argument omits two essential considerations. The export duty is not and cannot be supported by corresponding excise duties in the foreign country, and,

secondly, the foreign country, instead of being a limited area, consists of the whole commercial world.

If export duties fell wholly or mainly on the foreign country, it would surely be to the economic interest of all nations to adopt export duties, but in modern states they are insignificant compared with import duties.

The complete abolition of duties on exports would hardly affect the finances of the European states, whilst anything that disturbed the revenue from imports would be the cause of grave concern to nearly all nations.

The mercantilists imposed specially heavy duties on certain exports, *e.g.* on the raw materials of manufacture and on the instruments of production. These duties, however, were intended to *check* exportation rather than to yield revenue; and in the extreme case, which was very common, they were intentionally prohibitive. The idea was to preserve peculiar national advantages for the home producer, and in some cases to cheapen important commodities to the home consumer. The case of *revenue* export duties is quite different. As regards the incidence on the first imposition, the trader will ask the foreign consignee to pay the duty, but whether the foreigner will consent to do so, in whole or in part, depends on the possibility of his obtaining substitutes and on the intensity of his demand. With the extension and development of commerce and the advance of the practical sciences bearing on industry, the possibility of finding substitutes is vastly increased and the intensity of demand is proportionately lessened. If, however, the foreigner can obtain his supply from other sources, plainly he will not pay the tax. Accordingly the producers of the export (including the

whole series engaged in completing the act of production by delivery into the hands of the foreign consumer) must pay the tax, or the trade must cease or be greatly diminished.

If the taxed commodity comes under the rare category of national monopoly, it is possible that the whole of the tax may fall on the foreign consumer. The term *monopoly,* as in the case of import duties, again requires a careful interpretation. Even supposing that only one country, (say) England, produces a particular commodity, (say) smokeless coal, that is a "necessary" to other nations, it will not command a monopoly price unless all the producers make an effective combination.[1]

And, moreover, if there were such an effective combination which had secured a monopoly price, the export duty would fall wholly, or to a great extent, on the monopolists. If the trade would bear a higher price and yield a greater return, why did the traders not impose the tax for their own benefit?

If, however, the producers of the so-called monopoly had been competing with one another, then it is quite possible that the imposition of the export duty may cause a rise to the foreign consumer, and if his demand is highly inelastic, or he must get his supply *quand même,* he will pay practically the whole of the tax.

In this case there would be no check to the export trade, and accordingly no secondary disturbance of the home trade.

3. Rules for Taxes on Consumable Commodities. — The general canons of taxation have been applied to frame

[1] See above as regards import duties.

special rules for taxes on commodities. Only such taxes should be imposed as will yield a considerable revenue, or, in other words, the taxes ought to be *productive*.

The canon of *equality* enjoins that, if possible, taxes should be *ad valorem* and not specific.

The canon of *certainty* enjoins that the tariff should be clear to all concerned. One great difficulty in *ad valorem* duties is the uncertainty as regards tests of quality.

The canon of *convenience* finds its chief illustration in taxes on commodities. A large revenue may be raised from commodities when the limits of productiveness by direct taxation have long been left behind. Mill gives as his second rule that when possible the tax should be levied directly from the consumer. On the ground of economy this is perhaps theoretically justifiable, but it breaks down as regards convenience. It is much more convenient to the authorities and to the taxpayers to levy excise and customs duties than to attempt to collect the taxes directly from consumers.

The canon of *economy* also finds frequent illustration — both positive and negative — in taxes on commodities. Such taxes are more costly than appears at first sight. The official statements of the cost of collection of such taxes cannot include the indirect cost through the restraints imposed upon trade.[1]

4. Direct and Indirect Taxes Compared. — In spite of the evils that are associated with indirect taxation, and are only partially prevented by fiscal improvements, it has been found necessary by all the great nations of modern times to retain

[1] Cf. Cliffe Leslie's *Essay on Financial Reform*, Cobden Club Essays (1871–1872).

customs and excise duties as an important part of the tax system. In England, Russia, and France the excises and customs yield about half the national revenues. In Germany the imperial legislation regulates the customs and excises on salt, tobacco, spirituous liquors, beer, and sugar, and with three exceptions the constituent States do not tax these things. In the United States the federal government draws most of its revenue from excises and customs in nearly equal proportion. In comparing direct and indirect taxes both must be considered as parts of the whole tax system. The chief merit in either case is that the one remedies the defects of the other. Both are simply methods of taking wealth from private persons for public purposes. In favour of direct taxes it is argued that the contributors know exactly what they are paying, and accordingly, under a system of representative government, it is supposed that they will exercise a judicious check on expenditure. On this ground it is a matter for regret that in Britain the limit of exemption from the income tax has been placed so high. On the other hand, however, it is maintained that direct taxation of incomes below a certain minimum involves disproportionate sacrifice, and the mode of payment causes a still greater loss. Direct taxes cannot be collected piecemeal. It was found in Germany that in the case of smaller incomes direct taxes were paid by selling and pawning the furniture — an evil which still prevails in spite of the rise in the limit of exemption. Except on their first imposition, the amount of indirect taxes is not known by the taxpayers. An old tax is no tax in many senses — *inter alia* it seems to form

part of the natural or cost price. How many of the consumers of spirits and tobacco have any idea of the portion of the cost that depends on taxation? This concealment of the burden, though it may be convenient to the taxpayer, is likely to promote extravagance on the part of the government. Direct taxation in many forms is liable to the frauds incident on self-assessment or other modes of evasion. The British Income Tax has furnished startling examples, and the American property tax is still more notorious. On the other hand, taxation of commodities is a direct encouragement to adulteration and to smuggling.[1]

[1] *Principles*, Chap. XIII, and works cited above.

CHAPTER VII

FREE TRADE AND PROTECTION

1. Meaning of Free Trade. — Free trade is sometimes used in a loose popular sense as equivalent to *laisser faire* or non-interference; but historically it refers to a particular policy as regards international or foreign trade. In this sense its principal characteristics are absence of differential duties and of artificial encouragements such as bounties by which the home producer would be favoured as compared with the foreigner in the same industry. The essence of free trade is equality and uniformity in the financial treatment of home, colonial, and foreign produce of the same kind. Thus taxes on commodities for revenue purposes only, although they are of foreign origin exclusively (*e.g.* tea), are not held to infringe the rule, nor are duties on imports, provided there are corresponding excise duties on similar products. Similarly, absolute prohibition of imports, if equivalent penalties are imposed on the home production, does not offend against the principle of free trade (*e.g.* immoral books or prints). The principal practical difficulty arises in the interpretation of "substitutes" and "similars." It is not easy to find a fair common measure for home and foreign articles that differ in quality. Thus with wines, beer, and spirits the alcoholic test alone is obviously unfair; and a simple *ad valorem* tax is also inequitable, because the effect on demand will

vary in different cases. In a sense, indeed, any taxation of foreign goods which cannot be produced at home (*e.g.* tropical produce) gives an artificial encouragement to home industries. If tea and coffee are taxed, the use of aërated waters and home-made wines may be encouraged. The case of drawbacks presents similar difficulties. If the drawback is exactly the equivalent of the duty, it simply restores trade to the state of freedom; but if it exceeds the original tax, it degenerates into a bounty, and, indeed, most bounties on exports are disguised in the form of drawbacks.

2. Free Trade and the Consumer. — If the question be regarded solely from the point of view of the consumer, it is easy to establish the general case in favour of free trade. With freedom of competition no foreign commodity would be imported unless it could be sold at least as cheaply as when produced at home, and in general it may be said the foreign article would only gain an entrance by being offered at a lower rate. Thus to discourage importation by taxes would be to raise prices. Free imports encourage cheapness and abundance. It may also be argued that free exports give the greatest encouragement to free imports, whilst bounties on exports by lessening the supply at home raise prices to the home consumer and lower them to the foreigner.

On the whole, if the *consumer* only is considered, and the indirect effects on production are left out of account, free trade is generally advantageous, and the exceptions though of theoretical interest are of relatively small importance.

It may be objected, however, that all cheapness is rela-

tive to the means of purchase, that is, to incomes of the consumers, and that in the last resort incomes depend upon production in the large sense of the term.

3. The Protection of Home Industries: General View. — At first sight it seems plausible to assert that if foreign products are wholly or partially excluded from the home markets, there must be so much more employment for home labour and capital, and thus an increase of wages and profits. The refutation of this fallacy in its crude form is one of the greatest triumphs of the political economy which the successors of Adam Smith rendered simple and popular. The main positions in the refutation are indeed derived from Adam Smith. Bastiat's petition of the candle-makers against the sun, praying for the closure of windows in order that the production of artificial light (and all the subsidiary industries) might be encouraged, was probably suggested by Adam Smith's illustration that wine could be made from grapes grown in Scotland.

Again, the argument that industry is limited by capital, and that a government cannot directly augment capital, and, consequently, at the best can only determine the direction and not the volume of industry, is also taken directly from Adam Smith. Protection on this view may increase employment in any favoured industry, but it can only do so by withdrawing productive power from other industries in which the country has a greater natural advantage. The great maxim of free traders that imports must be paid for by exports amounts to saying that if foreign labour is encouraged by the free admission of foreign goods, home industries must be equally encour-

aged because goods to an equal value must be exported to pay for these goods. Conversely, protection by preventing imports must discourage exports. In any case, also, the very object of protective duties is to raise the prices of the protected products in the home markets, and accordingly the consumers so far suffer and they have less to spend on "other things." Not only do the labourers lose as consumers, but protection to some industries leads to a lessened demand for the products of other industries, and "the mischief circulates."

There is no doubt that these elementary arguments embody important practical truths which, as history proves, are liable to be overlooked. At the same time, however, the case for free trade has been greatly weakened by neglecting to make clear the assumptions implied and the qualifications to which they give rise.

4. The Assumptions of the General Argument for Free Trade. — In the *first* place, it is assumed that labour and capital can be turned without loss or difficulty from a decaying into a thriving industry, and that if any home product is displaced by foreign competition, "something else" can be made immediately with the displaced productive power. But it may be objected that every industry requires a certain amount of specialised capital and peculiar skill and training. There is so much force in this objection that Adam Smith himself pointed out that freedom of trade should only be restored by slow gradations if the employment of labour would be endangered. And, conversely, it may be argued that "temporary" protective duties should be enforced when an old industry is suddenly attacked by foreign competition.

The difficulty of the transference of capital, however, is likely to be exaggerated, and the argument for vested interests may be turned round. One great practical objection to "temporary" protective duties — for whatever reason granted — is the danger of creating vested interests which cannot be disturbed without some kind of compensation.

Secondly, the popular general argument assumes that the capital and labour of a country must remain within its own borders. This position again is in the main so true that it is taken as the basis of the theory of international trade. But the appeal to history also shows that industries may migrate, not only from place to place within a country, but also from country to country. Thus, foreign bounties might destroy some important home industry which, even after the removal of the bounties, the country might never recover. More generally a free-trade country placed in the midst of a group of protectionist countries is liable to disturbances and attacks which may vitally injure its industries. The case of "trusts" is at present the most important. Protected in the home market, they can sell there at monopoly prices; and abroad they can sell below cost.

Thirdly, the maxim that imports are paid for by exports may be reversed. No doubt all trade is reciprocal, but it may be said that unless a country's exports are sent by the best route to the best market, they cannot purchase so great a quantity of imports, and we may more reasonably regard the export trade as active and the import trade as passive than the converse. If, for example, to take an extreme case, other nations or an important combination effectually

excluded English exports from their markets, England would be unable to pay for her imports, and imports must cease.

Practically, no doubt, the foreign countries concerned could not afford to lose the English market for their goods if the closure were applied suddenly and extensively, but the danger lies in the cumulative effects of foreign protective duties, and the gradual exclusion of English goods from foreign markets. The natural remedy would appear to be found in commercial treaties on a reciprocity basis; but the great difficulty for the free-trade country is that it has no particular advantages to offer in exchange.

Fourthly, the general argument assumes that so long as the capital of a country can be employed with equal profit, the method of application is a matter of indifference. Not only was this position not approved of by Adam Smith, but it was distinctively controverted by him.[1]

Adam Smith used as his principal test of the advantages of employing capital, not the rate of profit to be obtained, but the amount of labour employed in the home country, and the benefit derived from the direct consumption of the capital.

Fifthly, the popular argument, that if protection is good for one country against another, it must also be good for one district, town, etc., against others in the same country, which is supposed to be a *reductio ad absurdum* of protection, is, in reality, quite irrelevant and generally fallacious. From the national point of view, the migration of industries within its borders is a matter of indifference, or rather, is, in general, a national gain. Thus the

[1] See above, Book III, Chap. XV.

abandonment of the mediæval protectionist system in which every town protected itself against all others, and insisted on its "ancient customs," was accompanied by a great expansion of industrial power; but, at the same time, while some places waxed, others waned. And, although this parochial protectionism has disappeared, the commercial rivalry of nations is as strong as ever, and the land would fare ill from which the capital and labour migrated, though the rest of the world might gain. There is not only the possibility of a "something else," but of a "somewhere else" to be considered; and herein lies the danger of organised attacks by foreign competitors.

The popular argument that the natural employment of productive powers, which, at the time, is most profitable, is also both immediately and ultimately the most advantageous to a nation, also breaks down theoretically when applied to particular cases.

5. Theoretical Exceptions to Free Trade.[1] — The principal theoretical exceptions to free trade may be deduced from the possible disadvantages of foreign trade to a particular country, which was considered in connection with the general theory of foreign trade (Book III, Chap. XV). At this stage, where we are rather concerned with the advisability of giving practical effect to the theory, a simple enumeration of the important cases must suffice.

It is said, *first*, that every nation should retain for the benefit of its own people any peculiar natural resources,

[1] *Special cases for the application of protection* would perhaps be a better title for this section. Compare Bastable's *International Trade*, Chap. IX.

and if possible any inventions and artificial means of production. It is impossible, however, as regards the remote future, to tell whether the peculiar value attached to natural resources will continue, whilst the immediate injury to trade is obvious. Just as sea-coal displaced charcoal, so water power and electricity may displace steam; and as regards the export of machinery, prohibition is useless when things can be imitated, and the limitation of export would check development.

A *second* exception to free trade has been urged on the ground of national independence. Adam Smith apparently approved of the principle of the Navigation Acts, although it is generally forgotten that when dealing with colonial policy he strongly condemns all the regulations and machinery by which this principle was carried out. And as a matter of fact this was the first part of the mercantile system to be severely attacked. This argument of national independence was chiefly relied on by the opponents of the repeal of the Corn Laws, but it now needs no showing that Britain has gained far more in military strength through the growth of wealth and population than she has lost by the contraction of corn-growing.

Again, the inter-dependence of nations is mutual, and the best guarantee for peace is the extension of commerce.

A *third* exception to free trade is especially applied to new countries. It is argued that protection is necessary to promote manufactures and the growth of towns, and that such development is necessary even for the encouragement of agriculture, *e.g.* wheat and frozen meat may be exported, but not all the by-products of agriculture, and in any case there is a loss in the cost of carriage. That

the commerce of the towns causes the greatest improvements in the country, and the nearer the consumer is brought to the producer the better, are favourite positions of Adam Smith.

It may be answered, however, that temporary protection is impossible owing to the creation of vested interests, that new countries especially require capital, which is repelled and diminished by protection, and that the artificial forcing of new industries is not advantageous in the long run. Professor Taussig has shown by a detailed account of the development of the cotton, woollen, and iron manufactures in the first part of the nineteenth century in the United States that, though all the conditions were favourable to the protection of young industries, little if anything was gained.

A *fourth* exception is the celebrated case of retaliation. This has been generally approved, provided the object is to compel the foreigner to take off objectionable duties. The practical objection, however, is that retaliation is likely to provoke further retaliation rather than reciprocity.

A *fifth* exception to free trade is found in the alleged necessity of protecting highly paid labour against the pauper labour of foreign countries. It may be replied that high wages do not make dear labour, and that they promote efficiency; and if protection is necessary to keep up the rate of wages, the higher wages are a tax upon the consumers of the article produced, and in general the higher nominal wages are gained at the expense of a fall in real wages. Still, theoretically, this exception is valid under certain conditions, and cheapness to the consumer

may be of less importance than the well-being of the producer.

A number of exceptions to free trade are to a great extent political and social, and only partially economic in the narrower sense. This is partly true of the cases already noticed, and in other cases is still more marked. Sometimes the object of interference is to injure other nations, as the Navigation Acts were mainly directed against the Dutch; and sometimes conversely to conciliate by conceding advantages, as in the case of the great French Commercial Treaty of 1860. The exclusion of certain foreign products is sometimes justified with the view of improving the quality of home labour. No nation would be content to remain as a hewer of wood and grower of corn, and the higher the forms of industry in which the workers are engaged so much the better for the nation as a whole. The great argument of Frederick List is that protection is necessary for social development.

It is assumed that if foreign wares of the higher class are excluded, they will be produced at home by native artists and craftsmen. It is, however, at least as probable that the absence of foreign competition would check development, and that the best way to promote the higher forms of industry is not by the simple process of exclusion, but rather by improvements in the education of the people.

The natural result of free trade is to stimulate competition, invention, and variety of enterprise, whilst the natural result of protection is to establish routine methods.

Finally, there are certain exceptional conditions under

which it is theoretically possible by the judicious manipulation of duties to extract a certain amount of revenue from the foreigner. Such cases occur when the country in question has either a buyer's or a seller's monopoly; in the former case it may gain by import, and in the latter by export, duties. Technically, duties of this kind infringe the general maxims of free trade, and practically they are of little importance, and, so far as practicable, are likely to lead to retaliation and to foster national animosity.

On the whole, then, it appears that, at any rate in the case of highly developed nations, although there are many cases "worthy of deliberation," there are very few worthy of adoption. And this view is strengthened by the negative argument in favour of free trade and by the appeal to experience.

6. The Negative Argument for Free Trade. — It is one thing to allow that provided a government were perfectly wise and perfectly powerful — in brief, a *deus ex machina* worked by perpetual motion — it might impose such taxes at its frontiers as would not only yield a revenue in some cases, but in others would assist in directing the labour and capital of the country into the most advantageous channels; but it is quite another thing to admit that any government is capable of managing the affairs of a great nation in this way. Those who quote Adam Smith for his theoretical exceptions, forget that he always laid most stress on the negative side of his argument; that is to say, on the weakness and incapacity of governments. His final opinion is that the statesman who should attempt to direct private people in what manner they ought to

employ their capital, is guilty of dangerous folly and presumption. This opinion is confirmed and illustrated by the appeal to history elaborated in the fourth book of the *Wealth of Nations*. And, if here and there a few fragments of the old policy have been rescued from the general wreckage by the labours of subsequent writers, the cumulative effect of the argument has hardly been weakened. Nor has it been much affected by the history of the nineteenth century, if in the interpretation the fallacy of *post hoc ergo propter hoc* is avoided. In the United Kingdom there can be little question that the rapid industrial development that has occurred was only possible through free trade. And, as regards the United States, it must be remembered that the immense area over which internal free trade prevailed was amply sufficient to secure most of the benefits of free competition. Similarly, the recent experience of German trade is associated with the Zoll-Verein over a wide area.

In conclusion, one other aspect of the negative argument may be emphasised. As regards most countries, the total foreign trade is a minor part of the whole trade. Even in the United Kingdom there are at present fewer persons employed in all the textile trades than in agriculture. The aggregate value of the receipts of the railways of the United Kingdom is about equal in amount to the total value of yarns and textile fabrics exported, which again is about one-third of the total exports.

And not only is the foreign trade only a minor part of the aggregate trade of most nations, but the utmost effect of artificial restraints and encouragements is relatively still less. Protective duties and bounties, at the best,

can only direct the employment of a comparatively small amount of the labour and capital of a country; the greater part will be employed according to the natural and acquired advantages of the country relatively to those of other countries. "The tariff system of a country is but one of many factors entering into its general prosperity" (Taussig).[1]

[1] *Principles*, Chap. XIV; List, *National System of Political Economy; Wealth of Nations*, Book IV; Sidgwick, *Political Economy*, Book III, Chap. V; Taussig, *Tariff History of the United States;* Patten, *Economic Basis of Protection;* Bastable, *Theory of International Trade*, also *Commerce of Nations;* Gladstone, *Financial Statements;* Buxton, *Finance and Politics;* Dowell, *History of Taxation*, Vol. II; Morley, *Life of Cobden;* Armitage Smith, *The Free Trade Movement;* Farrer and Giffen, *The State in its Relation to Trade.*

CHAPTER VIII

PRINCIPLES OF PUBLIC EXPENDITURE

1. Nature of Public Expenditure. — "The question of expenditure," says Professor Bastable, "is just as much a financial problem as that of revenue. Neither in theory nor in practice is it advisable to separate them completely." The opinion of Mr. Gladstone is still more emphatic, "Good finance consists more in the spending than in the collecting of revenue."

Public expenditure is limited by public revenue, and the greater part of revenue (under actual conditions) is limited by the productiveness of taxes, by the consent of the taxpayers, by the indirect effects on the productive powers of the country, and various other economic and political facts, which together place an insuperable barrier to the indefinite expansion of taxation.

The objects of public expenditure, on the other hand, are many in number, and in no case is it possible to reach the satiety point. There is thus a perennial struggle between conflicting claims, *e.g.* the navy and army, education, poor relief, sanitation, etc., and it is difficult to decide on the best method of distribution.

Under a system of popular government (with expenditure constantly increasing) a reference to principles is more than ever necessary. There are also questions of fundamental importance regarding the best methods of

expenditure, and we ought to consider (as in taxation) the indirect as well as the direct effects. And indeed the treatment of taxation may in almost every particular be made the basis of a similar treatment of expenditure.

Just as taxation is *compulsory*, from the point of view of the sovereign power, so also from the same point of view public expenditure may be said to be *arbitrary*. If, however, we trace the historical development of taxation and expenditure, we find that just as the compulsion of the former has been modified by the representation of the taxpayers, so also the control of expenditure in the interests of the public has been substituted for the arbitrary caprice of the sovereign power. The principle of no expenditure without the consent of the representatives was, however, only converted into a maxim of finance long after its analogue in taxation had been accepted; and the principle of appropriation of supplies was not definitely established till after the Revolution of 1689.

Again, the ancient rule in England, that all proposals for expenditure must come from the crown, which had its origin in the mediæval conception of sovereign power, has been developed into the modern constitutional doctrine that the ministry is responsible for the estimates submitted in the Budget. Thus, although the representatives of the people may throw out a government for the expenditure it proposes, they cannot directly substitute other schemes.

The furthering of the people's well-being was long regarded only as a means to the ends of the State. "*L'état c'est moi*" and "*pauvre royaume pauvre roi*" are concrete expressions of the same idea.

The same process of development may be seen with

regard to the management of the industrial domain of the State and of royalties and similar sources of revenue. The old idea was that, as in the case of private estates, the property of the crown should be managed so as to yield a maximum net revenue. The modern idea is that the production of net revenue is altogether of secondary importance. The post-office and, since the fall in silver, the mint, both produce in England a net revenue, but the yield of revenue ought to be considered as purely incidental if not accidental. The present tendency in local finance to look to municipal trading for the relief of rates seems, from the point of view of history, regressive rather than progressive.

2. Classification of Public Expenditure. — It might, perhaps, be thought of the nature of a truism to assert that public expenditure ought to be for public purposes; but in expenditure as in taxation the *quid pro quo* principle is sometimes applied.

It is better to take separately the two distinct ideas that are blended in this principle; namely, the idea of benefit and the idea of payment made. As regards *benefit* alone, all kinds of public expenditure must be held to confer a common benefit or to satisfy a public want as their essential justification, although they also — all of them — incidentally confer special benefits on individuals or classes or localities. Thus defence ostensibly is for the common benefit only; but as a matter of history most wars have been undertaken in the defence of particular places or classes or even individuals. Poor relief is ostensibly for the benefit of the particular individuals concerned; but as a matter of public policy it confers common benefits in the

prevention of crime and in the satisfaction of the sense of justice or of charity. Free education manifestly confers special benefits both on the particular children and their particular parents; but, again, the common benefit is very great. Finally, as regards the expenditure, which is said to confer only a *special* benefit on *individuals*, it may be said that the final cause of all progress in public expenditure has been the abolition of this class. From being the greatest, it has become the least in importance. Public expenditure which does not confer some common benefit or answer some public purpose, ought not to exist in the modern State. One of the greatest financial reforms has been the substitution of the principle of common benefit for the benefit of particular "interests."

Even if the particular individuals benefited pay the whole cost of the undertaking, and, to take a still stronger case, even if they pay so much as to give a profit, public management is not justified unless it can be shown that some public interest is subserved.

The payment for the benefit conferred ought not to be considered from the point of view of the individual. The penny that is paid for sending a letter to New Zealand does not in any sense represent the benefit to the particular individuals directly interested.

The basis of classification from this standpoint ought to be the whole amount of revenue obtained by the State in return for the services rendered. On this basis public expenditure may be classified as follows:—

First, expenditure without any direct return by way of revenue, *e.g.* poor relief; or in extreme cases even with indirect loss, *e.g.* expenditure on war.

Secondly, expenditure without direct return, but with indirect benefit to the revenue, *e.g.* for education, it being supposed that eventually the educated are better tax-payers or cause less expense as paupers or criminals.

Thirdly, expenditure with partial direct return, *e.g.* education for which fees are received, subsidised railways that pay part of their expense.

Fourthly, expenditure that obtains a full return or in extreme cases yields a profit in addition, *e.g.* the post-office, gas-works, and generally state industries.

3. Analogies from Taxation. — Other characteristics of taxation suggest corresponding analogies in expenditure. Corresponding, for example, to the illegitimate *evasion* of taxes we have the illegitimate appropriation of public funds — an enormous evil in former times; whilst to the legitimate evasion of taxes by the process of substitution may be likened the claims for doles and subventions from the treasury or the evasion of the duty of self-support.

All taxes, it has been seen, fall on *persons*, although nominally imposed on things or transactions. The natural correlative might appear, on first inspection, to be that all public expenditure benefits particular persons. Such an inversion, however, is not in conformity with the general characteristics already described. It would rather appear that in public expenditure the benefit to the individual is not the primary consideration. The State must rather be held to spend public money for public objects, and the nature of these objects is determined partly by history and tradition, partly by various political, religious, social, or moral ideas and ideals.

On the strict analogy of the definition of taxation the definition of public expenditure may be formulated: —

Public expenditure is the distribution by the sovereign power of the revenues of the State for the service of the public powers.

4. The Principles of Expenditure. — In considering the principles of public expenditure we may take as a guide the corresponding principles of taxation. There is then much need to emphasise the position that just as demand and supply, consumption and production, exports and imports, are correlative and inter-dependent, so also are public revenue and public expenditure.

The simple doctrine of *sovereignty* as the basis of taxation finds its analogue in expenditure in the position that the State spends its revenues according to the dictates of the sovereign power. The further question, however, at once arises, What should determine the dictates of the sovereign power? The general answer, as in the case of taxation, is that the money should be used in the manner most conducive to the public interest. It took many centuries to convert this saying from a paradox into a truism.

It may also be argued, pursuing the former line of inquiry, that one great public interest is justice, and that the analogue to *equality of sacrifice in taxation* is *equality of benefit in expenditure.* But even as regards taxation, it has been shown that equality of sacrifice, considered as the ultimate basis or test, is open to serious objections, and these objections are far stronger when applied to the converse case of equality of benefit in expenditure. The greater part of public expenditure is for public objects in

which no attempt can be made to distribute the benefit amongst individuals, *e.g.* the cost of defence.

The ideal of *minimum* sacrifice, or disutility, seems much better adapted than equality of sacrifice for conversion into a maxim of expenditure. The natural analogue, it may be said, to minimum disutility in taxation, is *maximum utility* in expenditure. And although the application of the conception is rather formal than material, it may be of service as a regulative idea and as a destroyer of fallacies, especially when expressed with reference to total and marginal utilities. There is no more popular fallacy than to suppose that because some kinds of public expenditure are classed as necessary, therefore they must always rank before those which are only classed as optional. Although the utilitarian calculus cannot be applied very far, the distinction between total and final utility may often indicate the necessity of checking extravagance in one direction and beginning expenditure in another. A minimum amount of defence or protection may have assigned to it an infinite utility, but the utility rapidly diminishes, and necessity passes into luxury or display. The ideal of public expenditure on the utilitarian principle would be attained when the public utility of the marginal expenditure in each case is equal.

The most popular application of the utility theory is in favour of increasing the expenditure on the poor and needy. Logically, however, the principle may be applied in favour of diminishing public expenditure on the rich or less needy. From this point of view the idea of making old age pensions universal is absurd; to the poor in very deed, and to the deserving poor in particular, the

utility of a moderate pension would be very great; but to those already provided for by children or friends the pension would be a bad substitute for natural charity.

On the same principle there is no reason why education should be free in all cases because in the public interest it is made free in some.

The maxim that the State should not do for people what they can do for themselves, may also be supported on the principle under consideration. It may well happen that state aid, which is very useful in extreme cases of poverty, becomes less and less useful as we ascend in the social scale, and finally becomes harmful or mischievous.

The application of the *faculty* theory to expenditure gives as the first result that the standard must be objective, not subjective. Such an objective standard is provided in the constitutional rule that the money voted by the popular assembly is appropriated, and can only be applied, to certain specified kinds of expenditure. The taxes that are levied according to faculty are expended according to public requirements, which admit of a definite, concrete statement. The apportionment amongst these public requirements is determined by the representative government, which again represents various ideas and various interests.

The *social* and *political* effects of public expenditure are generally of even greater importance than in the converse case of taxation. The primary object of taxation is to raise revenue; the social effects are indirect and secondary. But the very object of public expenditure is to attain certain social and political ends. The corresponding analogue, however, to this aspect of taxation, seems

rather to be that in expenditure also there may be indirect and secondary effects which sometimes are considered of more importance than the primary or ostensible object. The ulterior effects may altogether exceed in benefit the immediate results, as in the claim made for free education. On the whole, it may be said that in public expenditure (as in taxation) great care should be taken to avoid indirect evils, and the hopes placed on indirect benefits should not be exaggerated. These, no doubt, are formal counsels, but they are none the less useful guides for the arrangement of facts; and the reference to history shows their vital importance, — witness the indirect effects of public expenditure on the church, the poor, and the privileged classes.

The principle of *formal justice* may also be applied to expenditure. If public money is spent on any public object, it should be spent on other objects that are practically similar. The Kantian imperative, "Act on a maxim which thou canst will to be law universal," is certainly the golden rule for the exchequer. It must be observed, however, that special benefit may be conferred on one class or area or industry, without infringing this maxim, if thereby the public would benefit — whilst in other cases apparently similar this would not be the case. The actual expenditure of public money for defence no doubt benefits certain districts, *e.g.* naval ports and military centres, and it benefits, also, certain industries; but such particular benefit is only secondary and conditional. The real object ought to be efficiency in case of war, and not false charity in time of peace.

The great use of the rule is negative: never act on a

principle that cannot be extended, *e.g.* do not give to the Irish cottar what you will not give to the Scottish crofter. It may, however, be admitted that sometimes the State should revert to the mediæval device of making experiments, limited in various ways in time and place.

Much of the public expenditure for local purposes is provided by local taxation. If the benefit, *e.g.* a public garden, is purely local, the poorer localities, on this principle, have no claim on the central government or on richer areas for assistance in providing the benefit; but conversely, if the expense is to fulfil a public duty, *e.g.* compulsory education, such a claim holds good and is generally recognised.

Public expenditure ought to be definite and *certain*, and open to *public* criticism. The appeal to history is decisive, both as to the reality and the importance of this rule. The secrecy in respect to public revenue and expenditure that was formerly so noticeable, and which has been expelled by the growth of constitutional government, had extremely injurious effects. On the one hand, prodigality and injustice often escaped notice; while on the other hand, fair and legitimate taxation and expense were, through ignorance, frequently regarded as grievances. Publicity and responsibility have been shown by a lengthened experience to be necessary conditions for an efficient administration of finance. The efficiency of the machinery depends in the last resort on the practical wisdom and the incorruptibility (direct and indirect) of the individuals who represent the people.

In practice, also, publicity involves an independent and searching audit. "Of all expedients for the preservation

of public property, it is the most simple, ready, and self-acting."

The canon of convenience may be best illustrated from the opposite. The local finance of England afforded a striking example, until the recent reforms, of the inconvenience of a multitude of boards spending money for different objects. "The truth is, we have a chaos as regards authorities, a chaos as regards rates, and a worse chaos than all as regards areas" (Mr. Goschen in 1871).

One great difficulty in the control of expenditure is to reconcile the necessary routine of official practice with the convenience of the public. This difficulty is most serious and noticeable in times of war or other public strain, although at all times the inconvenience associated with red tape is proverbial.

In general, however, the canon of convenience, in the larger sense of the term, may be brought under the canon of economy.

Magnum parsimonia est vectigal ought to be applied in every budget; parsimony in one direction may avoid taxation in another. The usual practical rules by which economy, in this narrow sense, is attained must, however, be widely extended with the development of the term *economy*.

Economy in the means is the natural corollary of equity in the objects of expenditure. The aim ought to be to attain these objects in the most effective manner. Anything that is paid by government beyond what is requisite for efficiency is inequitable; it benefits one class, or rather a few members of one class, at the expense of the public. It is true, no doubt, that there is room in state expendi-

ture also for the economy of high wages, and even in the purchase of materials the dearest may be the cheapest with governments as with individuals; but high wages are only economical in proportion to efficiency, and high prices in proportion to quality. At the present time there is a recrudescence of an old fallacy: that the government ought to set the example of paying high wages — from the lowest to the highest appointments. The idea seems to be that the chief factor in the determination of wages ought to be the benevolence of the employer, and that as the government obtains its funds without any real cost, its benevolence should be so much the greater. Neither supposition will bear analysis.

Similarly, as regards the purchase of commodities, it is sometimes thought that the government ought to give more than private people. Economically it ought to give less. It buys in larger quantities, its payments are certain, and its custom is valuable as an advertisement. And if in a case of need or of monopoly the State has a right to modify prices in the public interest, so it may also modify them in the interest of its own administration of public affairs.

The principle of economy may sometimes be applied directly as a check on state enterprise. All unproductive expenditure involves taxation, and all productive expenditure that is to pay its cost must either be a monopoly which so far involves taxation, or it must be conducted like any other business. If private enterprise or voluntary association is sufficient to meet any public want, the government, whether central or local, should generally let it alone. The chance of profit is balanced by the chance

of loss, and the simple plan of taxation is preferable to speculation for profit as a method of providing public funds.

A number of subordinate or derivative rules of expenditure may be derived from the clue afforded by taxation. Government expenditure should be directed to a comparatively small number of great objects, and not to a multitude of small affairs. A driblet here and there is sure to offend against the canons of equity and economy. Grants in aid tend to be given in response to popular clamour or as rewards for political services, and so far take the place of the ancient pensions and direct bribery of the representatives of the people. It is sometimes said government should do a certain thing because the expense is trifling. A trifling expense, on the contrary, shows, as a rule, that it is no fit matter for governmental action. Trifling expenses ought to be met from the small change of charity, not from the millions of public revenue; if necessary, they should be the occasion not of appeals to government, but to persons.

A good system of expenditure should as far as possible be self-regulating; it should expand (and contract) with the public requirements. With growing wealth and population it is necessary to provide for increasing expenditure, and the various departments should be so constituted as to admit of natural expansion. At the present time this rule ought to be specially applicable in the provision for the naval and military services. Again, contraction of expenditure according to lessened requirements in certain branches is necessary both for economy and substitution. The expenditure also, in the various departments, ought to

be accurately estimated. In practice, the normal expenditure should be met from normal revenue. Supplementary votes and extraordinary demands should be avoided as far as possible — otherwise the control of Parliament becomes nominal. It is bad policy if Parliament is only made to sanction expenditure already accomplished.

In the progress of society, moreover, it is necessary to incur new modes of expenditure. No provision of machinery to meet old wants will suffice for the satisfaction of new demands. In many cases, however, the expense ought to be met not by increased taxation, but by substitution. With increase of wealth the increasing demands for education ought to be partially met, at any rate, by diminished demands from the poor; as the education rate rises, the poor rate ought to fall.

Finally, in case of a conflict of rules, if a compromise is impossible, the guidance of the stronger must be accepted. It may be said, for example, of expenditure, with still more force than of taxation, that a considerable degree of inequality is preferable to a small degree of uncertainty; inequality only affects the private interests of particular persons, whilst uncertainty vitiates the whole system of public administration.[1]

[1] *Principles*, Chaps. XV, XVI; Bastable, *Public Finance; Wealth of Nations*, Book V; Plehn, *Public Finance*.

CHAPTER IX

COLONIES AND DEPENDENCIES

1. Early History of British Colonies and Dependencies. — As in the case of other European nations, most of the British colonies were founded, and most of the dependencies acquired, under the influence of political ideas and ideals that would no longer be tolerated. Take first the case of colonies. It might naturally be supposed that the pressure of population and of capital at home gave a stimulus to colonisation, as in the case of the old Greek cities. It was, however, not the overflow of well-being, but of disorder and injustice in Europe which peopled and cultivated America.[1] Religious persecution and political intolerance drove out Puritans, Quakers, Catholics, and Jews to make new settlements. Later on, the transportation of criminals relieved the prisons of the home country and provided the colonial plantations with labour. The colonial labour market was further replenished by kidnapping and so-called apprenticeship, and by the importation and rearing of slaves.

As the colonies grew in wealth, the mother country paid them more attention. The most obvious device to obtain a large share of that wealth for itself was to prevent it going to other countries, and an elaborate system was devised for the monopoly of the colonial trade. "The

[1] See *Wealth of Nations*, Book IV, Chap. VII.

maintenance of the monopoly," said Adam Smith, just before the revolt of the American colonies, "has hitherto been the principal, or more properly, perhaps, the sole end and purpose of the dominion which Great Britain assumes over her colonies."

At the very time when Adam Smith was writing it occurred to some of the most foolish and ignorant of our rulers that it would be an excellent thing to impose taxes on the colonies for imperial purposes; and by the famous duties on tea they succeeded in raising about £300 and in losing the American colonies.

It might naturally be supposed that this sharp lesson would have established, immediately and forever, the principle of non-interference in colonial affairs. But the contrary was the case. The colonies, however popular their institutions, were really governed by British ministers from Downing Street. In crown colonies this power was exercised directly; in the free colonies it was exercised indirectly, through the governors and their councils. Self-government was there in theory, but in practice the governors ruled according to orders from England, and were, in general, able by devious means to command the consent of the local legislators.[1] Very often the interference was more direct. Acts affecting only the internal affairs of the colonies were disallowed by ministers at home. The public lands were considered the property of the crown, and often obnoxious grants were made. Even religious institutions and endowments were regulated from home. One of the greatest abuses was patronage. Infants in the cradle were endowed with colonial appointments,

[1] Cf. Erskine May, Vol. III, p. 160.

to be executed through life by convenient deputies. Extravagant fees and salaries were granted by England, raised by the colonies, and spent in England. Politicians who consented to exile themselves to the colonies were, in general, those who were wholly unfit for employment at home.

It is not surprising that the first years of the reign of Victoria were marked by a rebellion in Canada. The wonder is that Britain contrived to retain her dominion.

The retention of dominion, indeed, was effected through the abandonment of the powers of irritation and abuse. To Canada, over fifty years ago, and to other free colonies, as they obtained sufficient importance, the principle of responsible government was conceded. It is beyond the sphere of economics to describe the nature and effects of these political concessions or recognitions. Suffice it to say, that the general result is that a colonial constitution has become "the image and reflection of parliamentary government in England." And just as the crown in Britain has gained in popularity what it has lost in nominal power, through the transference of the supreme authority to the representatives of the people, so also the mother country, by accepting to the full the principles of local self-government, has strengthened, and in many cases has created, the far more real bonds of affection.

With regard to the dependencies, of which India may be taken as the most marvellous example which the world has ever seen, for a long period they also were given over to patronage and plunder and to all the methods of exploitation invented by unfettered companies. But with

the transfer of the powers and territories of the old East India Company to the crown came the recognition that the primary duty of the British government was to promote the large human interests of the millions of India, and not the narrow, pecuniary interests of a few British adventurers — great spirits though many of them were.

Thus it would appear that the extraordinary growth of affection on the part of the "possessions" toward the "possessor" during the reign of Victoria is to be ascribed mainly not to the conscious efforts of statesmen to carry out their ideas of "tightening the ties" of connection, but to the fortunate failures of such attempts; it is to be ascribed, not to the strengthening, but to the relaxing, of the powers of the central, or imperial, government.

This relaxation is seen especially in the abandonment of the remains of the old system of commercial monopoly. The recent denunciation of the commercial treaties with Belgium and Germany, and the grant to the colonies of essentially coördinate power in making such treaties, may be taken as the final step in the transition from monopoly to freedom. "The mother country[1] claims to be included on the 'most favoured nation' footing: the colonies cannot discriminate against a foreign state to which the mother country has by treaty granted the 'most favoured nation' clause; no colony, by direct or indirect negotiation, is to obtain an advantage at the expense of any other part of the empire, and should it obtain any concession

[1] See the historical survey in Professor J. Davidson's *Commercial Federation and Colonial Trade Policy*, Chap. II.

by way of preference from a foreign country the imperial government would endeavour to obtain similar privileges for the rest of the empire. These restrictions seem to constitute a minimum of empire, and weak as they are they are only retained by consent."

2. The Profit and Loss to the Mother Country of Colonies and Dependencies. — If now, in the light of this broad historical survey, we inquire what is the balance of profit and loss to Great Britain of this immense empire of colonies and dependencies, the answer at first sight does not appear to be very satisfactory, and the popular opinion that "something ought to be done" toward closer union seems plausible.

One after another the possible advantages of empire seem to have been abandoned or to have fallen short of realisation. Consider the question of revenue and expenditure. The great source of expense is found in the navy and army. The larger part of the expense is incurred, not for the defence of Great Britain and Ireland, but for the empire; and though India and the colonies may be called on to meet part of the expenditure for local defence, they contribute practically nothing to the expenses of the imperial government. Again, take the interest on the national debt. This debt is almost entirely due to wars for the maintenance and extension of empire, and not simply for the defence of the home country; but the United Kingdom alone pays the interest and bears the burden.

It is true that the recent war has revealed a surprising depth of filial affection on the part of the colonies and of India, and the former have contributed men and the latter

horses and material; but *per contra* the war itself with its enormous expense was a war, in the first place, in the interests of certain colonies, and not in the interests of the mother country, that is to say, if interest is to be measured by pecuniary gain.[1]

3. Trade and the Flag. — It may perhaps be thought that though we lose directly by the expense of our fleets and armies, we gain far more indirectly through the extension of our trade. In dealing with this argument two distinct questions must be carefully separated. In the first place, it is undoubtedly true that this country depends for the necessaries of existence — for food and raw materials of manufacture — upon supplies drawn from abroad; and it follows, as was admitted by Cobden, that we ought to keep the supremacy of the sea. But in the second place it is by no means so true that this extension of foreign trade has been due mainly to the extension of empire, and that this extension of empire has increased the security of our foreign trade. A few significant facts will show that if, to some extent, trade follows the flag, to a much greater extent trade pays no regard to flags. Our aggregate trade with foreign countries (including exports of British produce and imports) is nearly three times as great as with our colonies and dependencies;

[1] "You will find that every war, great or small, during the reign of Victoria, in which we have been engaged, has had at bottom a colonial interest, the interest, that is to say, either of a colony or of a great dependency like India. That is absolutely true, and is likely to remain true to the end of the chapter. If we had no empire, there is no doubt that our military and naval resources would not require to be maintained at anything like the present level." Mr. Chamberlain, as Colonial Secretary, at the conference of colonial premiers in London in 1897. See *Report of Proceedings*, p. 7 (C — 8596).

our imports from the United States are greater than the whole of the imports from all the British dominions.[1]

Nor can it be said that our trade is more secure owing to this vast and unwieldy extension of empire. Probably, indeed, the reverse is the case; the United Kingdom, as such, would be stronger with a concentration of empire in places specially adapted for the maintenance of a sea power.

The other commercial advantages which are supposed to follow from the possession of colonies also become much attenuated when tested by facts. The surplus capital and the surplus labour of this country flow at least as readily to the United States as to any of our colonies. From 1853 to 1898 the total emigration of persons of British or Irish origin was 8,549,569, of whom 5,690,712 went to the United States. The makers of modern empires have lost the Roman art of deportation: the Romans would have subdued the Transvaal with the mountain tribes of India, and civilised India by turning the stream of Irish emigrants from America. But though we have imitated the Romans unconsciously perhaps, but effectively, in the art of amalgamation, — by sparing the weak and warring down the proud, by encouraging also tribal wars, and, generally, by making the Briton a modern Roman citizen, any accidents to whom must be compensated in territory, — we have, perforce, abandoned this simple method of deportation. The colonies long

[1] In 1898 — a normal year — the aggregate trade (imports and exports of British produce) with *foreign* countries was £520,877,107; with British possessions, £182,660,716. In 1898 the imports from the United States were £126,062,155, and from all British possessions, £99,433,995. The total imports were £485,035,583, that is to say, the imports from British possessions were about one-fifth of the whole.

since refused to take our criminals, and they are now drawing the line at our paupers and Asiatics. In brief, our foreign trade and the migration of labour and capital are determined mainly by economic, and not by political, considerations. Labour follows wages; capital follows profits; and neither follows the flag. It is of course possible that if a foreign power acquired India, it would, by prohibitive duties, exclude British goods; but estimated merely by profit and loss, India does not pay the British taxpayer either directly or indirectly.

4. **Imperial Federation.** — The only "thorough" scheme for imperial federation ever propounded is that given by Adam Smith in the concluding chapter of the *Wealth of Nations*. It is, probably, far too thorough for acceptance by the feebler folk of to-day. His scheme was based on imperial taxation throughout the empire, and representation in proportion to taxation. He contemplated the possibility of the transfer of the seat of political power across the Atlantic in little more than a century; and but for the political accidents which occurred as he wrote, the present United States would have been the strongest part of the British empire, both in wealth and population, that is, so far as the English-speaking races are concerned. If, however, the education and political emancipation of the "black man" had advanced in India as in America, and the franchise were not tempered by property qualifications, India would be sending a majority of representatives to the Imperial Parliament; and the logical outcome of Adam Smith's scheme would be that the representatives of the United Kingdom would form less than 10 per cent of the whole.

If federation of this "thorough" kind does not seem possible, any reversion to the old methods of monopoly of trade and preferential duties seems equally unlikely to increase the economic advantages of empire to the mother country.

The method of estimating the advantages and privileges of empire in terms of money is, however, altogether inapplicable and fallacious. If Britain had parted with all the territory that did not "pay," she would not have retained in her empire a single colony or dependency, and even Ireland would have been cast adrift; and if the British colonies had forsaken their allegiance because they had no share in the British Parliament, equally, also, the empire would have disappeared. The empire has grown in strength because liberty and natural affection have been allowed to displace narrow economic interests. Consider the question of defence. Every year of peace and control strengthens the affection to the empire of the colonies, and makes it more and more impossible for any other power to take our inheritance. And in case the independence of the mother country were threatened, the resources of the whole empire would form a last reserve, all the stronger because it rested not on formal treaties or fixed contributions or shares in control, but upon gratitude and affection. Consider even the question of commerce. It is easy to say that free trade within the empire is desirable, and it is to be hoped that in the course of time this ideal will be realised. But this country would not gain if this ideal must be purchased by sacrificing a trade of threefold magnitude with foreign countries, by creating all kinds of local jealousies throughout the empire, and by

interfering with systems of taxation which the people who bear the taxes regard as beneficial or, at any rate, satisfactory.

Instead of seeking to "tighten ties," the ideal should be to enlarge the sympathies; and instead of trying to barter government for revenues, the people of this country should endeavour more and more to govern by consent.[1]

[1] This chapter is abbreviated from *Principles*, Book V, Chap. XIX — the greater part of the more controversial matter being omitted. See *Wealth of Nations*, Book IV, Chap. VII; Davidson, *Commercial Federation and Colonial Trade Policy;* Chiozza, *Free Trade and the Zoll-Verein;* Bastable, *Commerce of Nations*, Chaps. X, XVII. The article on "Colonies," in Palgrave's *Dictionary*, gives a useful bibliography and résumé. See also Lewis, *Government of Dependencies* (ed. Lucas), Introd., pp. xliv-lxii, and Chaps. VI–IX. Caldecott, *English Colonisation and Empire*, Chaps. VII, VIII.

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